Quarterly Economic Update

March 22, 2018

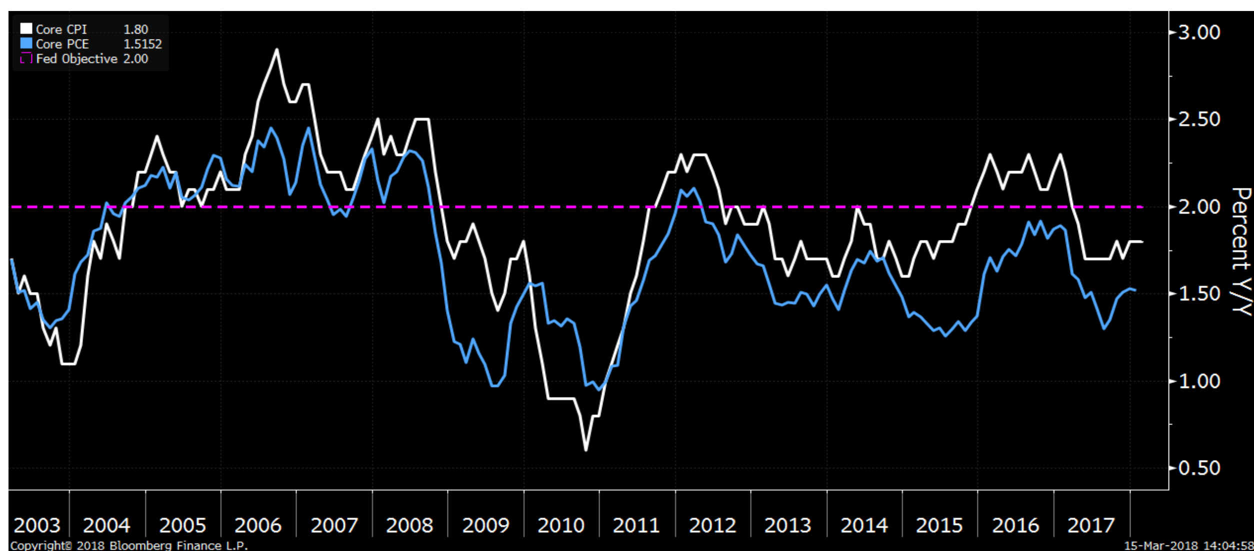
MACROECONOMIC COMMENTARY

Monetary Policy

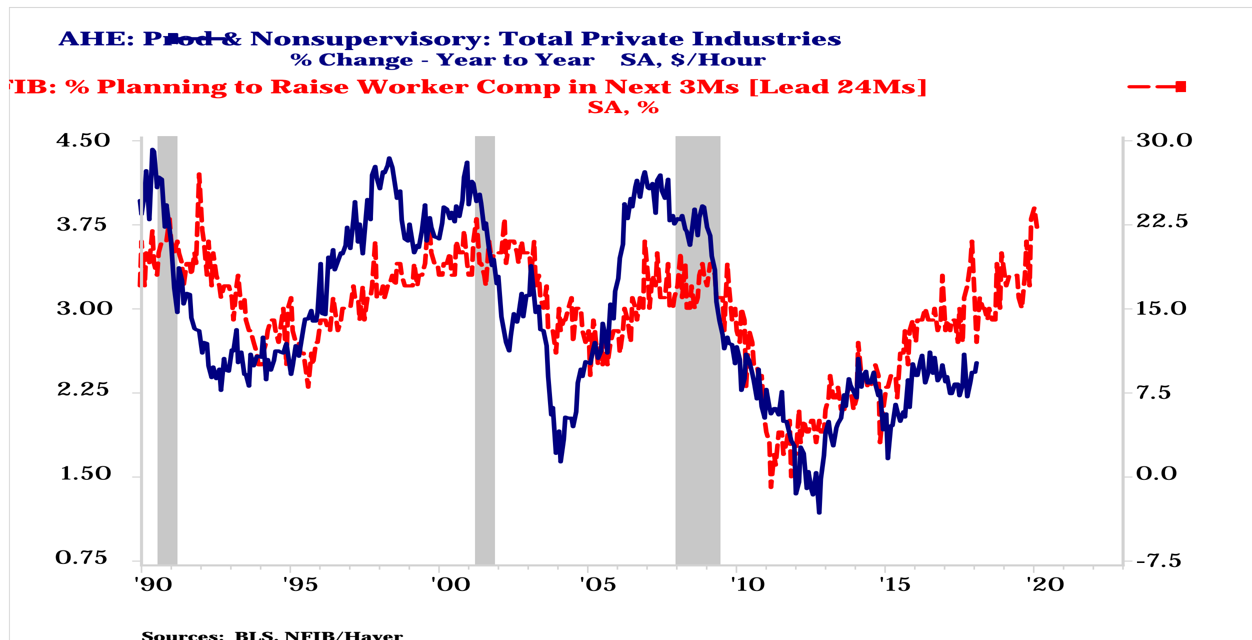
By Bobby Long

The Federal Open Market Committee (FOMC) last raised the federal funds rate at their December meeting, where they increased their target range to 1 ¼ - 1 ½ percent. The next FOMC meeting will be held on March 20-21st, with expectations they will increase the rate again with another quarter percent bump at that meeting. The committee continues to move forward with an approach of normalizing monetary policy as they gradually raise the federal funds rate and reduce the size of the Federal Reserve's balance sheet. Federal Reserve Chairman Jerome Powell has now taken over the reins from former Chair Janet Yellen and he has shown no indication that he will lead the FOMC forward on a dramatically different path. Chairman Powell has indicated they will continue to normalize policy at a measured pace, but as always monetary policy actions will be driven by economic conditions.

Labor market conditions have continued to improve with strong job growth and unemployment running low. Weaker inflation has been the more challenging side of the mandate with Core PCE persistently running below their 2 percent objective. Despite this, the FOMC has maintained that they expect inflation to move towards and stabilize around their 2 percent objective. Chairman Powell stated at his February Semiannual Monetary Policy Report to Congress that "we continue to view some of the shortfall in inflation last year as likely reflecting transitory influences that we do not expect will repeat." The chart below highlights the trend of Core PCE (blue line) running mostly below 2 percent since the economic recession.



Broad-based wage growth has been lacking, which combined with other deflationary pressures has left lingering questions about the level of inflation and additional slack in the labor market. FOMC minutes indicate that while there is debate and some disagreement around the level of wage growth, a "number of participants judged that the continued tightening in labor markets was likely to translate into faster wage increases at some point." Wages typically lag economic strength and tightening labor conditions, making it difficult to assess the true strength and breadth of wage pressures. Ultimately, stronger wages will likely serve to push inflation towards the FOMC's 2 percent objective. The February FOMC minutes reflected this view by noting "participants anticipated that inflation would continue to gradually rise as resource utilization tightened further and as wage pressures became more apparent." The chart below shows Average Hourly Earnings (AHE) tracking a little higher but still relatively weaker than preferred. The red line reflects a survey by the National Federation of Independent Business (NFIB) that an increasing number of small businesses are anticipating the need to raise wages in the next three months. This is a positive indicator for wage growth.



Source: Strategas Research Partners

As Powell and the FOMC attempt to normalize monetary policy accommodation following a decade of very easy policy, they are moving forward with a cautious approach to ensure they meet both sides of their dual mandate to promote stable prices and a maximum level of sustainable employment. There is risk in over or undershooting these goals, and Powell recently stated they will "continue to strike a balance between avoiding an overheated economy and bringing PCE inflation to 2 percent on a sustained basis." This leaves to question how aggressive they should be as they normalize policy. Prior FOMC forecasts have led expectations towards three increases to the federal funds rate in 2018, with another two increases in both 2019 and 2020. More recent expectations have been leaning towards the potential for four increases in 2018. We will receive more insight from the updated individual FOMC participant forecasts provided on March 21st, but this

will evolve as we move through the year based on economic conditions. Powell recently noted that “some headwinds the U.S. economy faced in previous years have turned into tailwinds” and that “fiscal policy has become more stimulative.” If inflation shows stronger signs of moving toward the 2 percent objective, then it opens the door for the FOMC to more aggressively raise the federal funds rate.

Fiscal Policy

By Michael McNair

Long-time readers of the Fiscal Policy Report will know that we have been harsh critics of the way politicians in Washington have used fiscal policy since 2010. The policy makers tasked with setting fiscal policy have failed this country by setting a fiscal position that is in direct opposition to the stance required by the economy. From 2009 to 2016, this nation has endured the largest and most persistent output gap since the Great Depression, while policy makers have orchestrated one of the largest fiscal drags in our nation’s history.

With interest rates near zero, fiscal policy is the most valuable tool at policy maker’s disposal to steer the economy to a more optimal outcome. The obvious drawback to fiscal policy is that its proper implementation is the responsibility of elected officials who often place political considerations above the needs of the country. Monetary policy, on the other hand, has the benefit of being controlled by a group of individuals that are relatively insulated from political concerns. The result has been a restrictive fiscal policy stance which has forced the Federal Reserve to run excessively loose monetary policy in order to negate the fiscal drag and stimulate the economy. The over reliance on monetary policy has led to a host of unintended consequences, the extent of which will only become clear in time.

Even the man who was in charge on implementing monetary policy, Ben Bernanke, believed that fiscal, not monetary, policy should have been the main tool used to stimulate an economic recovery. The former Fed Chairman took a parting shot at Congress on his way out of office saying, *“Excessively tight near-term fiscal policies have likely been counterproductive. Most importantly, with fiscal and monetary policy working in opposite directions, the recovery is weaker than it otherwise would be. But the current policy mix is particularly problematic when interest rates are very low, as is the case today. Monetary policy has less room to maneuver when interest rates are close to zero, while expansionary fiscal policy is likely both more effective and less costly in terms of increased debt burden when interest rates are pinned at low levels. A more balanced policy mix might also avoid some of the costs of very low interest rates, such as potential risks to financial stability, without sacrificing jobs and growth.”*

A Detour into Monetary Policy

The “Fed put” refers to the classic role of central banks to provide liquidity in response to a recession or financial crisis. Central banks, such as the Federal Reserve, typically react to longer-cycle and backward looking indicators of economic stress, including employment and inflation. But the financial markets are leading indicators for the economy and they will deteriorate before the economy

begins showing signs of weakness. Market participants know that once these longer-cycle economic indicators start deteriorating the Fed will add liquidity to the system, acting as a put option for markets and the economy. However, the large output gap that emerged after the Great Recession has allowed the Federal Reserve to react in anticipation of economic weakness by using short-cycle indicators of financial stress. In the post-Great Recession period, the Fed has added liquidity to the market in direct response to financial market stress, such as an increase in volatility or stock market declines, rather than to the fundamental economic data.

Central bankers' preemptive use of liquidity was well intentioned. They were worried that if the economy slipped back into a recession, it could be stuck in a Japanese style liquidity trap for decades. Unfortunately, even the best intentioned actions will still have unintended consequences. As Bernanke states, the consequence is that loose monetary policy is jeopardizing the stability of the financial system. Like Pavlov's dogs, market participants are quick to learn how the system is operating. The "Fed put" has been put on steroids (another way of saying this is that the strike price has increased) and markets are now pricing in supportive policies before they are even enacted.

Artemis Capital's Christopher Cole, states that *"Market behavior has now fully adapted to the expectation of pre-emptive central bank action to crisis creating a dangerous self-reflexivity and moral hazard. As markets now fully price the expectation of central bank control we are now only one voltage switch away from the razors edge of risk. Do not fool yourself - peace is not the absence of conflict - peace can exist on the very edge of volatility. The truth is that global central banks cannot remove extraordinary monetary accommodation without risking a complete collapse of the system, but the longer they wait the more they risk their own credibility, and the worse that inevitable collapse will be. In the Prisoner's Dilemma, global central banks have set up the greatest volatility trade in history."*

Cole's assertion is that central bank policies have caused markets to misprice risk which has increased the fragility of the system. The problem is that it isn't until a crisis hits that the scale of misallocated capital is realized. In his 1867 paper, "On Credit Cycles and the Origin of Commercial Panics", John Mills wrote that "Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works."

When is the system most vulnerable

The question of timing a crisis is not to determine when capital was misallocated, instead it is to understand when the system will be forced to recognize this misallocation.

It is first essential to understand that a financial crisis is similar to a bank run. It occurs when the liquidity needed to bridge the gaps created by a mismatch between assets and liabilities suddenly becomes unavailable or insufficient. Insolvency itself is not a sufficient condition to cause a financial crisis. The crisis

only happens when creditors finally refuse to roll over the liabilities that can't be serviced out of existing assets.

If an economy has a wide output gap and central bankers are providing liquidity in response to the anticipation of economic weakness, then the system is unlikely to undergo a crisis because liquidity will be made available.
However, the economy becomes susceptible to a crisis once the output gap has closed, because central banks become focused on containing inflation and will be reluctant to step in and provide liquidity to the system. The system becomes even more fragile if this economic tightening occurs after a long period of low economic volatility and interest rates have incentivized economic agents to take on increasingly risky positions.

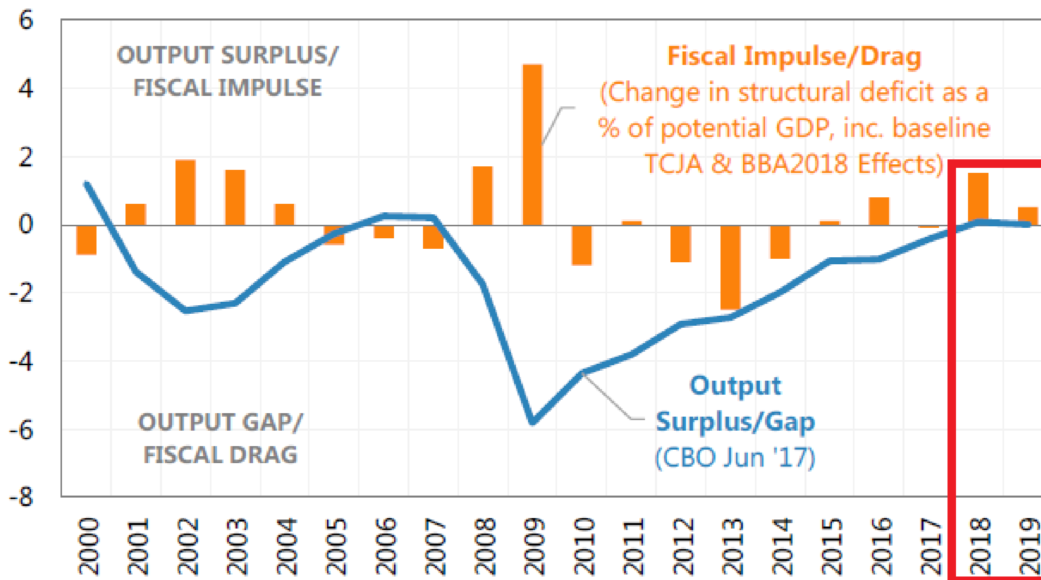
A Return to Fiscal Policy

Improper fiscal tightening forced the Fed and the ECB to rely solely on monetary policy to move the economy away from deflation. However, monetary policy is too broad a tool to be used to combat deflation without causing unintended consequences that jeopardize the stability of the financial system.

To some extent, Bernanke understood the risk of his unconventional monetary policy by explicitly stating that it poses "risks to financial stability". Despite the risks, Bernanke chose to print anyway, because he believed that the alternative (falling back into deflation) was worse. Only in hindsight will we begin to understand the extent to which Bernanke's policies lead to the mispricing of risk and the misallocation of capital. When that time comes, we should keep in mind that it was the contractionary fiscal policies of the last eight years that forced Bernanke to choose the best of only bad options.

After years of running restrictive fiscal policy during a period with significant economic slack, it is fitting that policy makers have finally decided to allow for stimulative fiscal policy now that the output gap has finally closed.

The chart below shows the CBO's estimated output gap in blue, and the estimated fiscal stimulus or drag in orange. The red box shows that, due to tax reform, fiscal policy is estimated to be "stimulative" in 2018 and 2019. We use stimulative in quotes because the impact of the government's fiscal policies could be anything but stimulative to the economy.



Most economists acknowledge the risks of increasing the budget deficit in an economy with little spare capacity, but they are taking solace in the fact that the projected fiscal stimulus is not enormous and that it might be good to run the economy hotter than typical due to years of inflation undershooting the Fed's inflation target.

The problem is that the neo-classical model of the economy fails to account for how the financial system allocates capital because they operate with the a priori assumption that capital is always effectively allocated.

They also have a static view of inflation and its ability to cause a recession. They fail to understand how the stability of the system can be put at risk by even a gradual buildup in inflation.

It is our belief that economists are failing to account for the risks that have built up in the financial system after years of low interest rates and unprecedented central bank liquidity to support asset prices.

Neoclassical economists make the mistake of creating a static model to account for how economic factors impact the economy. They make linear assumptions for how factors, such as inflation, will impact growth (i.e. if inflation goes up by "x", GDP will fall by "y"). However, the reality is that the economy is a dynamic system and the relationships between economic variables are non-linear. A dynamic system can stay in a steady state for a long period and then a small change in a single variable, at the right time, can create chaotic behavior in the system.

If you have a static model of the economic system you will have no chance of predicting when the system will exhibit chaotic behavior. In fact, your model won't even be able to account for how such an event could occur. However, if you have a more robust model for understanding how the components of the economic model fit together then you can understand when the system is most vulnerable to chaotic behavior.

In a typical recovery, inflation picks up near the start of the recovery when the scope of misallocated capital is small and economic agents are overly risk averse. In this state, inflation will not pose a risk to the economy. Yet, most economists, with their static model of the economic system, view this data as evidence that initial rising inflation correlates with positive economic outcomes.

In our dynamic model of the economy, inflation's impact will depend on the economic context. As the economic cycle matures, misallocated capital builds in the economy and the system becomes more fragile. As a result, the economy is more vulnerable to a pickup in inflation late in the cycle.

It will be quite ironic if stimulative fiscal policy in a tight economy forces the market to realize that the "Fed put" has been removed, and causes a repricing of risk. If persistent inflation then prevents the Fed from adding liquidity to a tightening financial system, we will finally see "the extent to which capital has been previously destroyed by its betrayal into hopelessly unproductive works."

The Fed has desperately tried to create inflation for nearly a decade. The advice from the Fiscal Policy Report: be careful what you wish for.

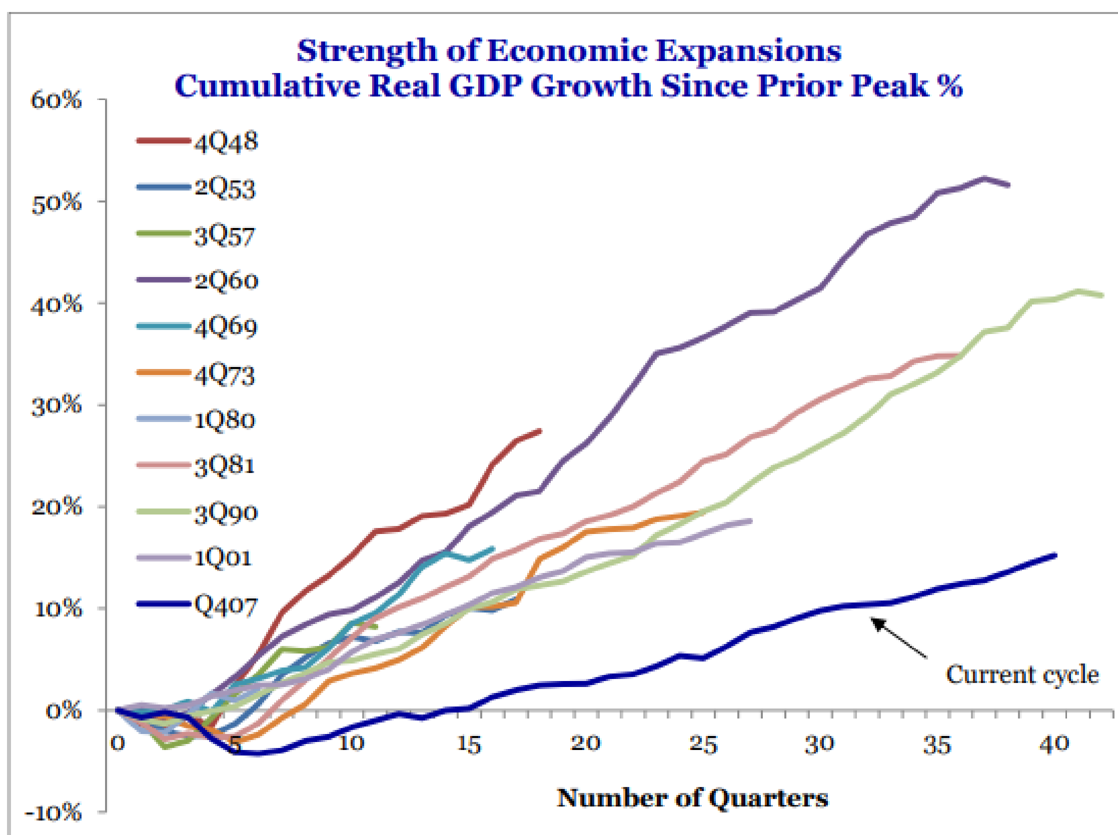
Economic Outlook

By Adam Rogers

Do you know where the expression "long in the tooth" comes from? It's an expression that was originally used to identify aging horses and a phrase we are routinely hearing in regards to this economic cycle, with the intended message being "watch out, this thing is getting old." Warnings of this nature resonate with people because throughout postwar American history we've become accustomed to a certain rhythm, a robust period of growth fueling wage gains, inflation, and rising interest rates which finally give way to recession, all occurring within a framework of time that is undefined but somehow bounded in our minds by what we've seen before. There is an uncommon and uncomfortable mismatch when a cycle weakly limps along for years without the speed and timing we've become accustomed to. It "feels" late, even though the data says we still have time.

In the chart below, the message is clear that this cycle is in rare company when judged by length of time, but fairly close to average in terms of overall growth attained. Comparable cycles of this length (there aren't many) produced real growth 3-4x greater than this one, and cycles matching the current cumulative growth have historically taken less than half the time to do so.

Exhibit 1: Slow and Steady



Source: Strategas

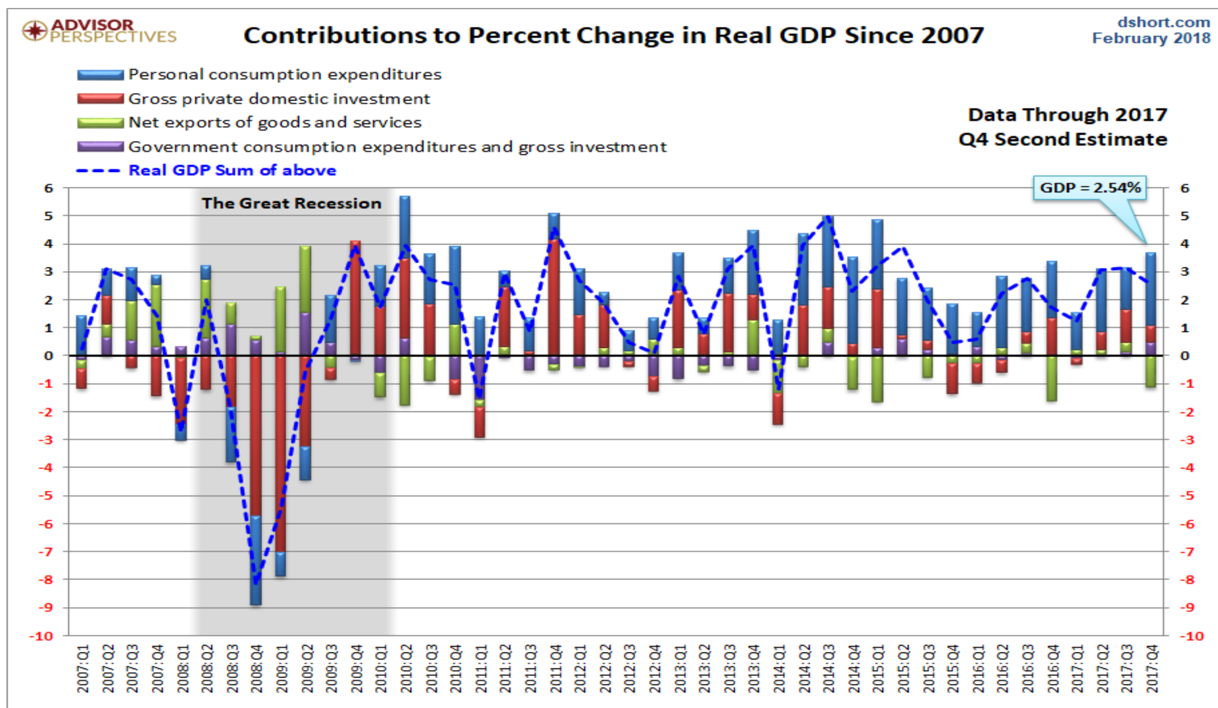
With this in mind, on the following pages we'll break down some of the recent economic data and hopefully capture a picture of how late in the cycle we truly are, regardless of how long it took to get here.

GDP

Growth in the fourth quarter was revised lower to 2.5% from the advanced estimate of 2.6%. As has been the case, the consumer did the heavy lifting as Personal Consumption Expenditures accounted for 69.6% of growth, a record high. Theoretically, there is an upper bound to this ratio and while we haven't tested it yet, we could be nearing that territory.

Overall, growth prospects have strengthened due to a range of ingredients. First, household income creation is being aided not only by a shortage of labor, but also from the newly enacted tax cuts. Second, mounting economic confidence has led households to lower their savings rate, transferring income gains directly into consumption. Third, business demand is improving, helped by a combination of strengthening animal spirits and rising capacity constraints. As a bonus, a weaker dollar and firmer global growth prospects could help spur net exports.

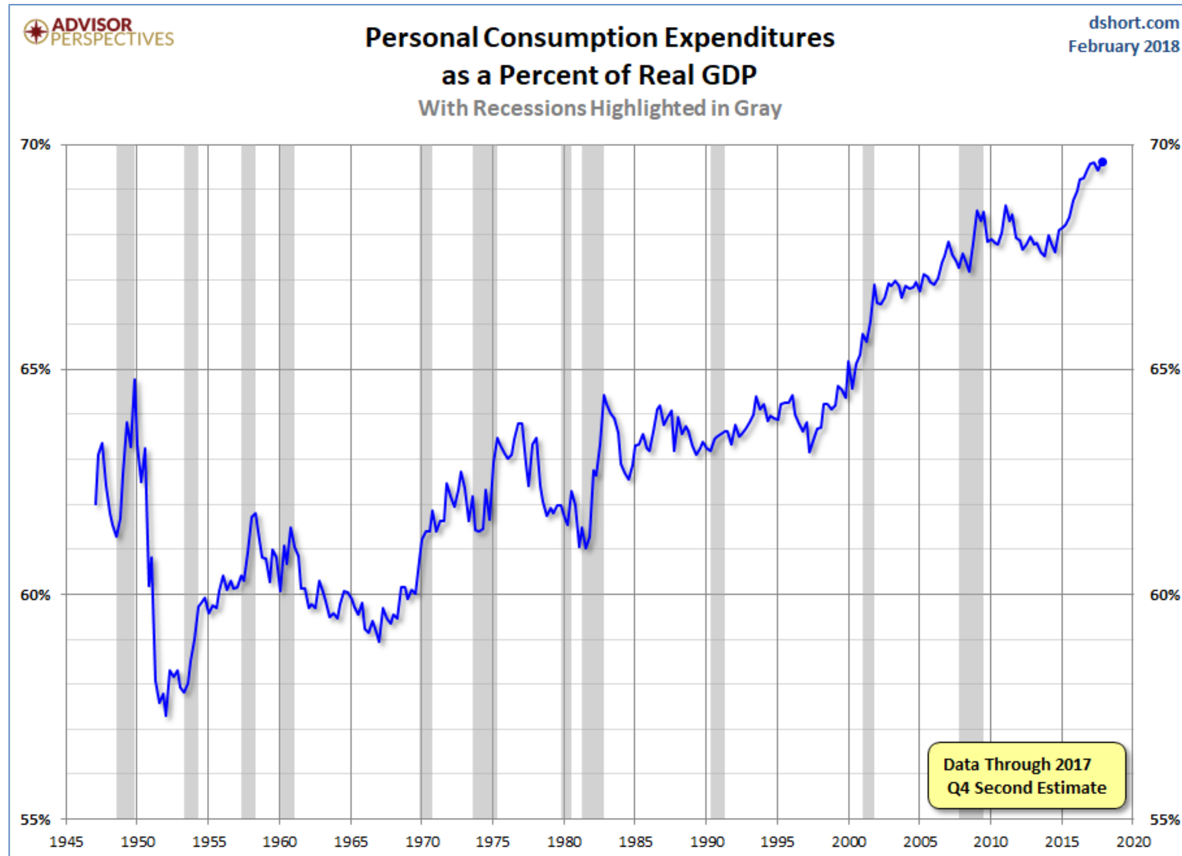
Exhibit 2: Components of GDP



Source: Advisor Perspectives

Additionally, the new Federal Reserve Chairman, Jerome Powell, in his first testimony in that capacity, had an upbeat view on short term prospects for growth, particularly regarding "meaningful incremental demand from fiscal changes".

Exhibit 3: PCE as % of GDP



Source: Advisor Perspectives

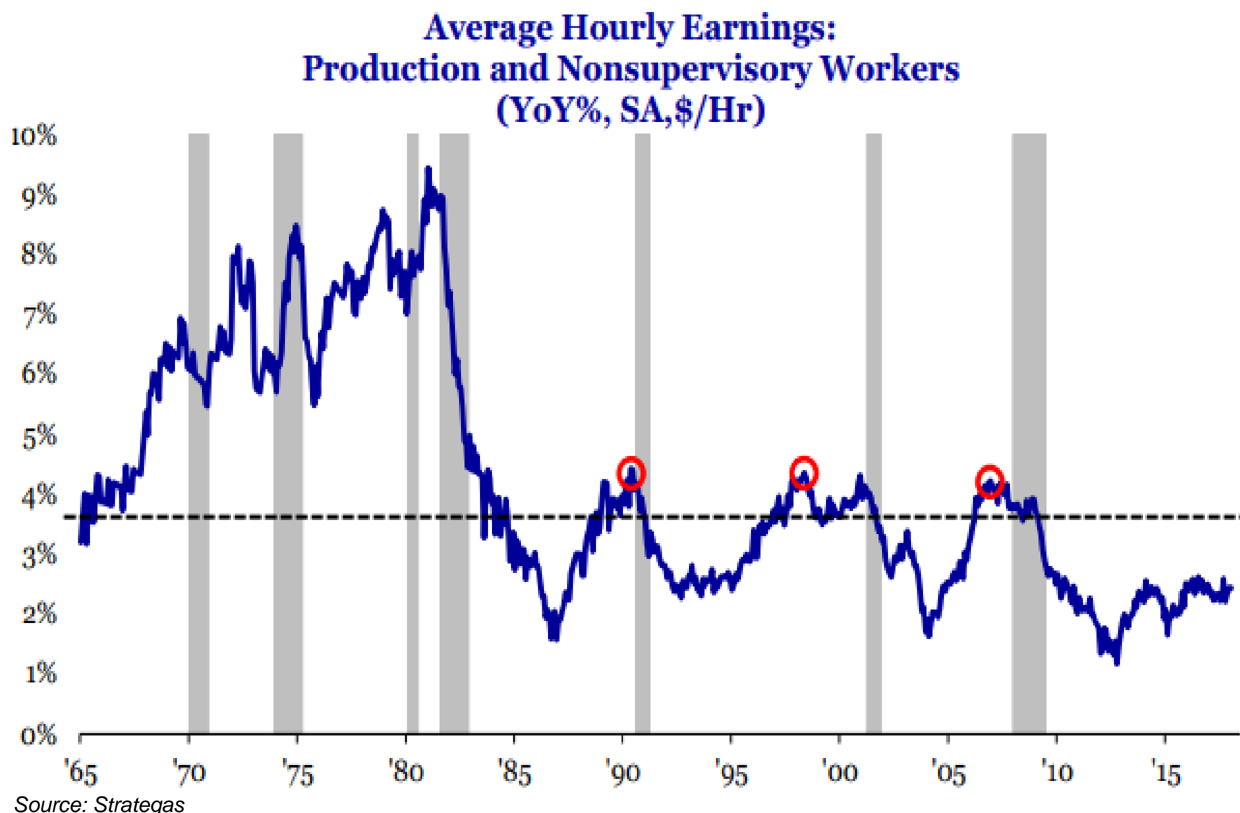
Wages and Labor

The message telegraphed by the latest jobs report is that while tight, the labor market still has room to improve. Employers hired the most workers since 2016, and the participation rate rose more than it has in eight years, all while wage gains cooled off from a weather-related jump in January. Of particular interest, the participation rate rose to 63%, indicating an 806,000 increase in the labor force and giving merit to the narrative that the strength and stability of this economy is just beginning to pull people off the sidelines, and that the labor market isn't quite as tight as the unemployment rate of 4.1% would lead you to believe. This is important because, typically, at this level of unemployment, wage gains start ramping up as labor has more bargaining power. The rise in the participation rate mitigates this effect.

For the purposes of judging this cycle's maturity, wage growth usually provides the cleanest signal. Annual growth of 4% in U.S. average hourly earnings is a level where corporate profit margins start feeling some pressure. However, once the 4% threshold is hit, it usually takes roughly 2 years before a recession. During this cycle, wage growth in particular has been sluggish, primarily due to weak productivity (a factor which appears to be picking up right now).

The combination of solid hiring gains and a lack of real wage pressure adds weight to the stance that this is a cycle still somewhere near a midpoint, as the Fed has a green light to proceed in a gradual, controlled fashion.

Exhibit 4: Average Hourly Earnings



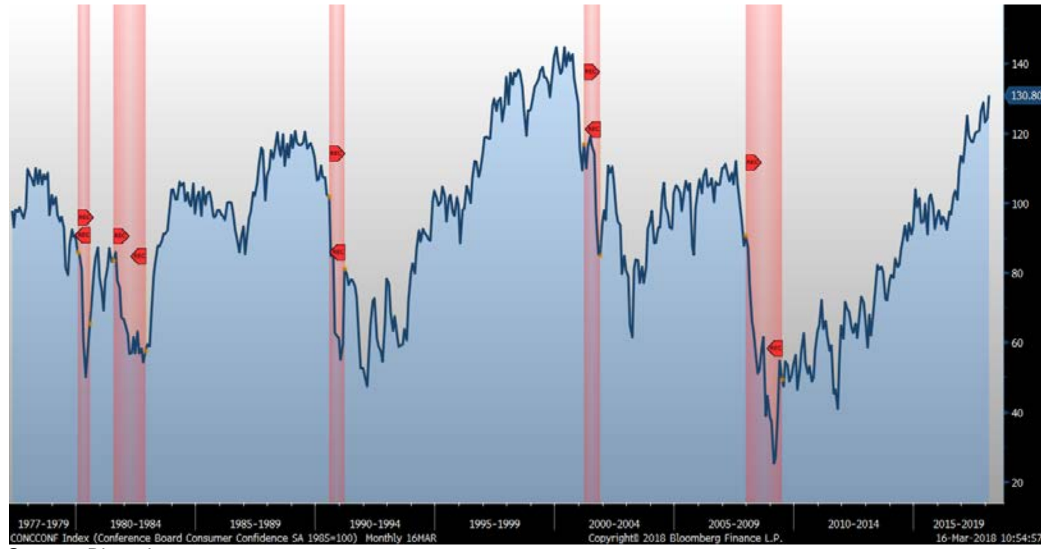
Source: Strategas

Consumer Confidence

The headline consumer confidence number stands at 130.8, its highest reading since 2000.

Almost a coincident indicator, consumer confidence usually plummets about 1 year before a recession. Despite all the recent market volatility, political sideshows, and slowly creeping inflation, the conference board measure hit a fresh cycle high in February, in line with our thesis that this cycle still has time and room. As stated earlier, households are upbeat, encouraged by the tax cuts and improving job prospects. We conclude from this survey that improving sentiment should play a role in economic activity outperforming the pace and pattern we've seen over much of this expansion.

Exhibit 5: Consumer Confidence



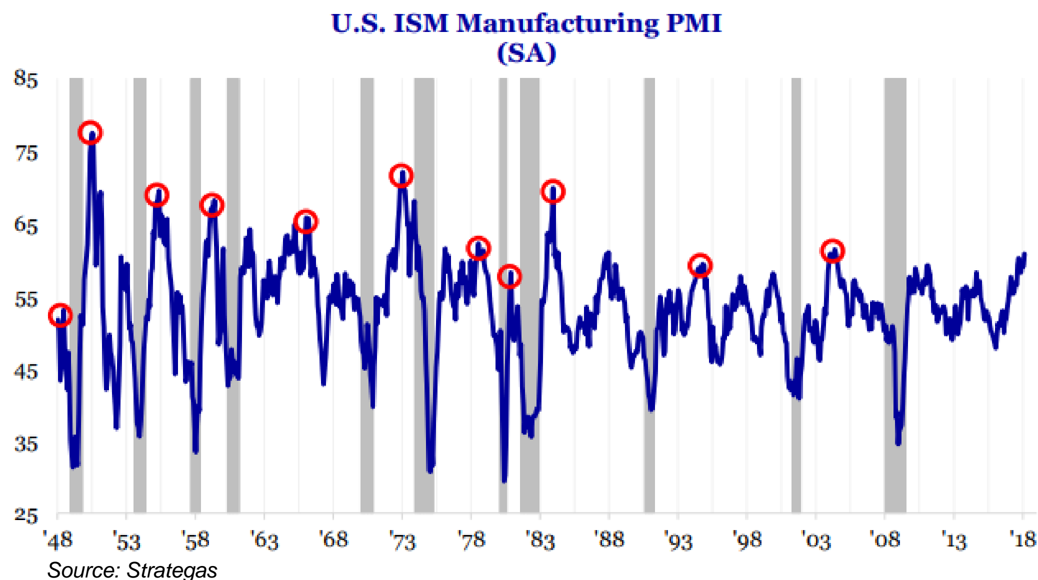
Source: Bloomberg

Growth, labor, and sentiment are all telling a similar story, and we'll finish with two more data points to back up our stance that this expansion still has time.

PMIs

Manufacturing isn't as large a factor in the overall US economy any more, but it is still sensitive to the cycle and makes for a good indicator on present conditions. PMIs can have multiple mini-cycles within the larger cycle, but as a rule of thumb, they peak 3 years before the onset of a recession. Many thought we had hit peak PMIs for this cycle in September, until they hit a new high of 60.8 last month.

Exhibit 6: PMIs

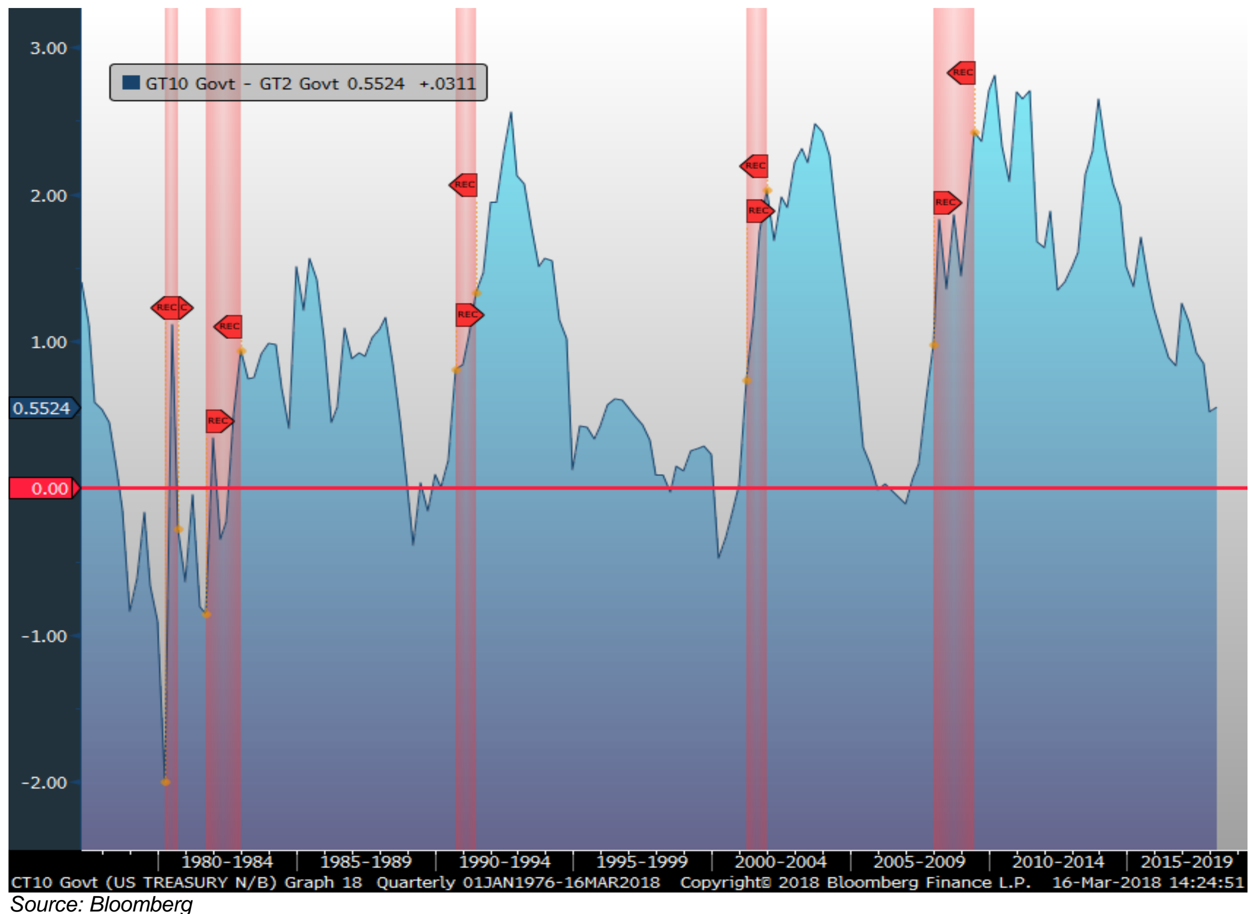


Source: Strategas

Yield Curve

A mainstay on everyone's radar, the yield curve typically inverts 1-2 years ahead of a recession. It is flattening as the Fed gingerly raises rates, but it hasn't inverted yet.

Exhibit 7: Yield Curve



Source: Bloomberg

In summary, this expansion is certainly long in the tooth from a timing perspective. The depth and severity of the previous recession led to a prolonged and slow recovery with an expansionary period that has yet to accelerate into an exciting pace. Things are beginning to heat up, and while most of the data points towards this continuing in the short term, we will continue to monitor these and other factors for signs of a turn.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our early December meeting, the S&P 500 was in the midst of a sustained upswing. The Treasury curve was flattening as shorted-dated yields were rising in expectation of further interest rate hikes by the FOMC while the long end remained flat due to the absence of meaningful inflation combined with uncertain fiscal policy. Credit markets were behaving well as corporates were moving in line with Treasuries.

After our meeting, the Federal Reserve did increase the range for the federal funds rate to 1.25 percent to 1.5 percent on December 13th, and said, "the Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong." Even though the Federal Reserve raised rates, risk assets fared well with the S&P 500 rising 1.11 percent as tax reform was passed on December 20th and economic data continued to come in strong per BofA Merrill Lynch. The Treasury market also posted a gain of 35 bps. This was largely caused by the relative stability of the long dated portion of the curve versus the sustained selloff on the front end. The Treasury curve flatted by roughly 10 bps in this environment which coincided with a 10 bp rise in the 2-year note.

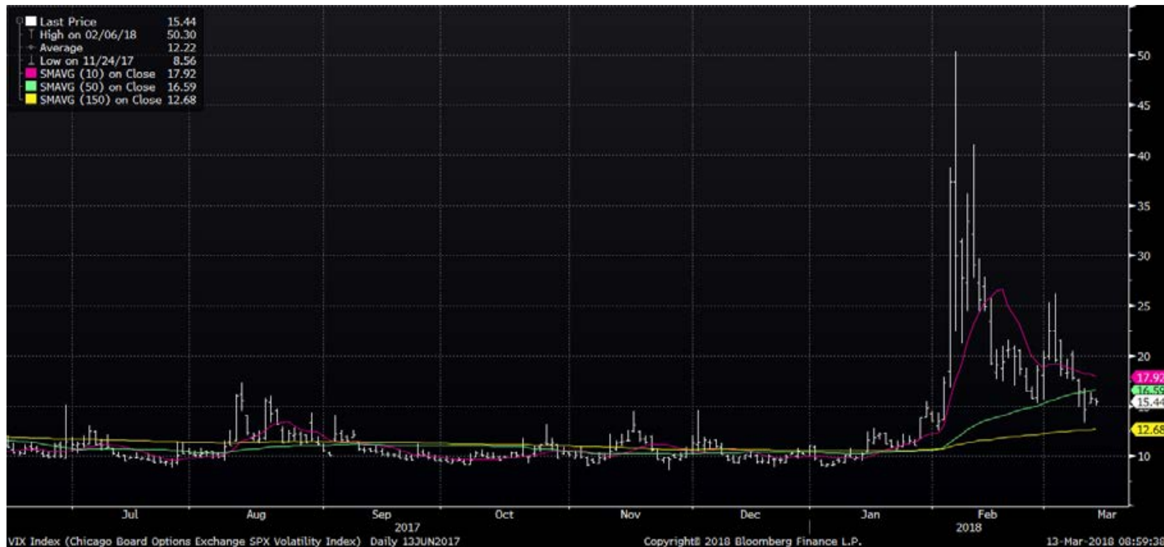
Spread products benefited from the risk-on tone of the market as mortgages tallied a 33 bp gain while agencies were up 15 bps. The 30-year Fannie Mae mortgage spread tightened by 12 bps versus the 5-year Treasury, which was a pretty significant move. Agency spreads were pretty contained with the CS Agency 3-5 Index tightening by 1.5 bps. In the corporate bond market, high grade fixed income securities registered an 85 bp total return as spreads compressed by 4 bps. Diversified media led the way with a 136 bp excess return on the back of Disney's purchase of Fox. Commercial and consumer finance was the laggard with an 11 bp excess return. High grade issuance was a paltry $27.8 billion which was the lowest December since 2001. High yield underperformed, both high grade and Treasuries, with a 29 bp total return per BofA Merrill Lynch. This was largely due to the sector's concentration on the front end of the interest rate curve.

The month of January was tremendous from an equity holder's perspective as the S&P 500 rose 5.73 percent on the back "of strong global economic growth, solid 4Q earnings, the impact of tax reform, and sharply lower dollar" per BofA Merrill Lynch. This same high performance was not, however, experienced by fixed income investors as interest rates on the short end of the curve continued their march higher while longer dated interest rates became unmoored from their stable base and surged upward. The 2-year Treasury yield jumped 25 bps while the 10-year Treasury yield rose 30 bps, so the curve steepened during this period. One of the catalysts for the bearish rate move was a report from Bloomberg News on January 10th which said, "Senior government officials in Beijing reviewing the

nation's foreign-exchange holdings, have recommended slowing or halting purchases of U.S. Treasuries, according to people familiar with the matter."

Various fixed income asset classes were able to outpace Treasuries in this environment. Mortgages and agencies returned -118 bps and -79 bps versus the -140 bps for Treasuries per BofA Merrill Lynch. This was primarily due to the differences in duration as both, mortgages and agencies, had less interest rate exposure than the Treasury index. On a spread basis, the 30-year mortgage spread versus the 5-year Treasury actually widened by 5 bps while the CS Agency 3-5 Index tightened by almost 2 bps. Higher coupon mortgages lagged lower coupon ones as their durations extended at a faster clip in the rates-up move per PIMCO. On the whole, the modified adjusted duration of the Bloomberg Barclays US MBS Index extended materially by 56 bps. In the corporate bond market, CreditSights said high grade corporates achieved a -92 bp total return and high yield posted a positive 64 bp total return. BBB-rated bonds had the highest excess return among high grade ratings while CCC-rated credits were the leader in high yield. Investors were clearly reaching for risk. Cyclical sectors such as metals & mining and independent energy led the way among investment grade names returning 241 bps and 200 bps in excess return. In high yield, oil field services was the outsized winner with a total return of 345 bps with retailers coming in second at 179 bps. On the supply front, high grade volumes came in at $130 billion in January with financials issuing a record $106 billion in the month while high yield sold $24 billion per Wells Fargo.

After a smooth January, volatility came back into the fold in early February as the strong January jobs report kicked off a bout of anxiety surrounding future interest rate hikes and caused a correction in stocks and bonds per BofA Merrill Lynch. The U.S Bureau of Labor Statistics said the economy added 200,000 jobs and wages rose 2.9%. Adding to the fragility of the market was the implosion of the short-volatility trade. Market participants had been shorting the Chicago Board Options Exchange Volatility Index, the VIX, for a number of years and over time, the short volatility trade had become large enough to actually drive the underlying index. On February 5th, the VIX spiked tremendously as investors covering their short volatility positions sparked a vicious feedback loop where buying the VIX caused the price to increase which then forced the participants to buy even more. The move can be seen in the chart on the following page. A couple of funds actually had to liquidate after losing the majority of their assets.



Source: Bloomberg

On that day, the S&P 500 was down 4.10 percent and the 10-year Treasury yield fell 13.5 bps. For the entire month, the S&P 500 settled down negative 3.69 percent. Though Treasuries did lose money on a total return basis, their negative 79 bps was significantly better than the stock market per CreditSights. Even in the midst of increased volatility, interest rates did move higher through the month. The 2-year yield was 11 bps greater while the 10-year yield rose 15.5 bps, thus producing a flatter curve.

Government-related bonds outperformed Treasuries as agencies lost 30 bps and mortgages fell 70 bps per BofA Merrill Lynch. Spreads in these two areas widened which is consistent with the risk-off tone that investors were exhibiting. The Credit Suisse U.S. Agency 3-5 Spread Index jumped out 10 bps while the 30-year Fannie Mae mortgage index versus the 5-Treasury note rose 6 bps. Even though the spreads moved adversely in this environment, lower duration profiles allowed these sectors to beat Treasuries. Mortgage duration extension continued into rate selloff as the Bloomberg Barclay's U.S. MBS Index's modified adjusted duration went from 4.99 years to 5.25 years by the end of the month.

Both, investment grade and high yield, struggled in this environment. According to Wells Fargo, investment grade "excess returns were negative across every sector as spreads widened amid climbing yields and deteriorating technicals" and ultimately resulted in a -62 bp excess return. Commodity related names fared the worst as refining and oil field services saw excess returns of -194 bps and -122 bps while airlines and REITS were the standouts at -13 bps and -19 bps. Investment grade supply came in at $94.4 billion which was higher than the $90.1 billion during the same period last year. For high yield, Wells Fargo said, "spreads widened abruptly at the start of the month, as macro volatility spurred heavy outflows, but recouped most of the move in the second half of the month" to produce a -52 bp excess return. Supply volumes had a poor month as issuance was down 50% or so from the prior year period. Diversified media and consumer products were able to shake off the gloom and posted 44 bps and 43 bps of excess return. Like investment grade credits, commodity names in high yield were

the clear losers as energy equipment services registered a -201 bp excess return per CreditSights.

The month of March has a seen a continuation of February's volatility. On one side, the strong February jobs number of 313,000 came in much better than the 205,000 jobs expected from the Department of Labor. On the other side has been the concern over Trump potentially starting a trade war with the implementation of steel and aluminum tariffs per valueline.com. The resignation of Gary Cohn from his position as the Director of the National Economic Council did not help reduce the market's anxiety. In this environment, the Treasury curve has flattened with the long end rallying. Mortgage and agency spreads have barely moved wider. As of March 14th, high grade corporates were 7 bps wider for the month and high yield bonds were 10 bps weaker per Stifel.

Since our last board meeting, RSA has made a number of adjustments to the fixed income portfolio. For Treasuries, we purchased a 2025 Treasury note to add money to the sector in an effort to reduce the underweight versus the index and to bring the duration in line. A 2022 Treasury was also added to raise the weighting though the trade marginally lowered the duration. Our outlook for this market is that interest rates on the shorter end of the curve will continue to march higher. The Federal Reserve seems intent on raising rates and said at their January 31st meeting, "The Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate". Currently, there is a 99.3% percent chance of rate hike at the March meeting and a 67.5% chance of an additional hike in June where the upper end of the federal funds range would reach 2.0%. From a technical perspective, the trend in 2-year note is clearly up as indicated in the chart below, so getting too bullish on Treasury notes is probably unwise as this stage.

Source: Bloomberg

The long portion of the Treasury seems to be in a large consolidation phase. The chart below shows repeated attempts by the 30-year Treasury to breach the 3.20% yield level but has yet to do so in a sustained way. There could significant selling pressure if the long bond can get out of this range. From a curve perspective, it should continue to flatten as the business cycle matures. The 2s/10s curve is currently at 56 bps. As of now, we are short duration reflecting the upward nature of yields and underweight the asset class. We will use selloffs to increase duration to help hedge the portfolio if a reversal were to occur.

Source: Bloomberg

Various trades were completed in the agency bond sector to better optimize the portfolio. Two intermediate-term bullets were sold which were trading fairly tight to Treasuries and the proceeds were rolled into a 3-bullet and an 11-year discounted callable issue. This barbell approach provided diversification on the curve where we were a little underweight and allowed us to pick up yield due to the longer callable issue. An additional curve diversifying trade was also completed as we increased our exposure to the shorter end of the curve with the purchase of a 2020 note. This helped us move closer to the weighting of the 1-3 year part of the index. Thirdly, RSA swapped out of a FNMA January 2022 issue and purchased a FHLB December 2022 note to pick up 10 bps of yield while extending out less than a year. Finally, we purchased a 6.5 year agency to reduce our duration underweight. Going forward, activity will be comprised of maintenance trades to remain market weight. We will also be opportunistic about adding callables if rates resume their uptrend.

The mortgage portfolio was fairly active in the last few months. For example, we purchased mutiple 30-year 3.0% coupon pools to give us greater exposure to the 7-year part of the curve, reinvest prepayments, and to add money to the space. To reduce the duration impact of these purchases, we added a 10-year Fannie Mae 3.0% coupon pool. Further duration reduction trades were later completed in the form of outright purchases of 15-year 2.5% and 3.0% coupon pools. As rates went higher, we reduced our overweight in 15-year pools and picked up yield by adding

30-year 4.0% coupon mortgages. One of those trades was a swap where we sold a 15-year 3.0% coupon pool and purchased a 30-year 4% security to add 58 bps in yield for only a 1.87 year increase in duration. In the future, mortgage spreads will be under pressure as the Federal Reserve unwinds its MBS holdings. J.P.Morgan estimates $165 billion of MBS will exit the Fed's balance sheet in 2018 and then over $200 billion will leave in 2019. An additional source of concern surrounds another major player in the mortgage market, Wells Fargo. The Fed Reserve instituded a balance sheet cap as a penalty for their recent scandal which widened MBS spreads when it was announced per PIMCO. This cap could impede the bank's future ability to buy mortgages. Regardless of these concerns, mortgages continue to offer the best spread among government-related spread products while not being exposed to credit risk like in the case of corporates. We remain heavily underweight versus the index but have decently raised our weighting. Being slightly long duration with a 15-year overweight looks to be a prudent strategy at this stage.

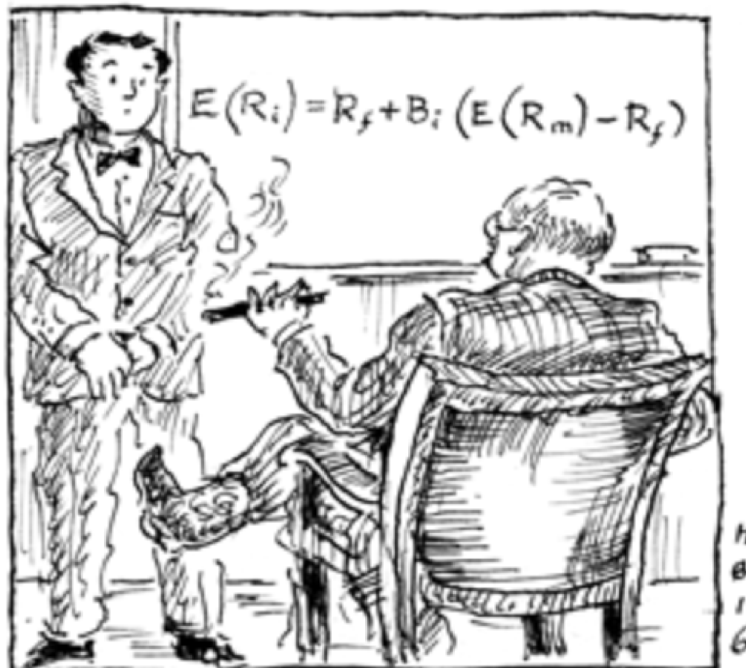
The corporate bond portion of RSA's fixed income portfolio had a number of transactions over the last few months. We focused primarily on the short to intermediate part of the curve as interest rates were moving higher. For example, we purchased a block of Citigroup July 2019's that yielded 2.468 percent with a spread of 54 bps. A 2024 Allergan issue was also bought and this trade provided a yield of 3.789 percent with a spread of 113 bps. One very short note we acquired was a July 2018 CVS Health Corp bond. The spread was 40 bps and the yield was 1.885 percent. We were comfortable earning a yield that was equivalent to a 3-year Treasury note for only 8 months of risk in a diversified health care company. RSA continues to maintain a large overweight in corporate bonds as the yield pickup over other fixed income products is still attractive. Our weighting has declined recently due to a number of maturities. We are of the opinion there will be greater volatility going forward for the asset class as spreads are fairly tight and interest rate hikes could potentially put downward pressure on the economy. We plan to be opportunistic in both, the new issue and the secondary market, focusing on solid corporate credits. The front to intermediate part of the curve still makes sense given the Federal Reserve's rates-up stance.

Domestic Equity Strategy

By Kevin Gamble

The U.S. equity market ended its perfect game so to speak by closing lower on a total return basis for the month of February. The year 2017 marked the first calendar year in history that the S&P 500 closed higher on a total return basis every month of the year (March was down slightly on a price basis but up on a total return basis when one includes dividends). While the streak inevitably had to come to an end at some point, the general backdrop for U.S. equities continues to be supported by several positive tailwinds as we look out over the remainder of our fiscal year and beyond.

What I would like to accomplish in this strategy piece is to simplify the current market backdrop for U.S. equities into a top 11 list of market observations which we at the RSA think are relevant in framing the risk/reward backdrop against which we are currently investing your money on the equity side of the ledger.



"Son, let's keep this real simple.
Up is good, down is bad."

Source: Strategas

RSA Top 11 list

1) S&P earnings are growing

This sounds basic, but is an obvious positive as we project out future levels for the market. Equity returns basically come down to the level of earnings and the earnings multiple. If earnings are growing, this is a big positive for projected returns as the earnings multiple would have to compress to prevent positive returns so long as the expected growth comes to fruition!

Exhibit 1: S&P 500 Forward Earnings Projections and Ratios

SPX ↑2776.67 +37.70 2776.28/2777.06
At 13:32 O 2752.91 H 2777.57 L 2751.54 Prev 2738.97
SPX Index 96) Actions 97) Settings Consensus Overview
S&P 500 Index
Periodicity A Flavor Y View Growth Currency USD

Measure	Actual	Y Est	Growth	Y+1 Est	Growth	Y+2 Est	Growth
1) Earnings Per Share	123.82	156.25	26.19%	172.53	10.42%	190.74	10.55%
2) EPS Positive	125.22	156.44	24.93%	172.66	10.37%	190.84	10.53%
3) Cash Flow Per Share	185.70	215.98	16.31%	240.69	11.44%	257.34	6.92%
4) Dividends Per Share	51.31	53.22	3.73%	57.49	8.01%	61.43	6.85%
5) Book Value Per Share	818.14	1102.97	34.82%	1420.82	28.82%	2337.17	64.49%
6) Sales Per Share	1221.04	1300.65	6.52%	1361.91	4.71%	1427.75	4.83%
7) EBITDA Per Share	233.83	274.64	17.45%	294.30	7.16%	317.99	8.05%
8) Long Term Growth	0.00	11.19	0.00%	0.00	0.00%	0.00	0.00%
9) Net Debt Per Share	346.70	469.47	35.41%	436.94	-6.93%	304.81	-30.24%
10) Enterprise Value Per Share	3135.98	3242.12	3.38%	3209.59	-1.00%	3071.24	-4.31%

Valuation Measure	Actual	Y Est	Y+1 Est	Y+2 Est
11) Price/EPS	22.42	17.77	16.09	14.56
12) Price/EPS Positive	22.17	17.75	16.08	14.55
13) Price/Cash Flow	14.95	12.86	11.54	10.79
14) Dividend Yield	1.85	1.92	2.07	2.21
15) Price/Book	3.39	2.52	1.95	1.19
16) Price/Sales	2.27	2.13	2.04	1.94
17) Price/EBITDA	11.87	10.11	9.43	8.73
18) EV/EBITDA	13.41	11.42	10.66	9.86
19) Net Debt/EBITDA	1.48	1.26	1.18	1.09

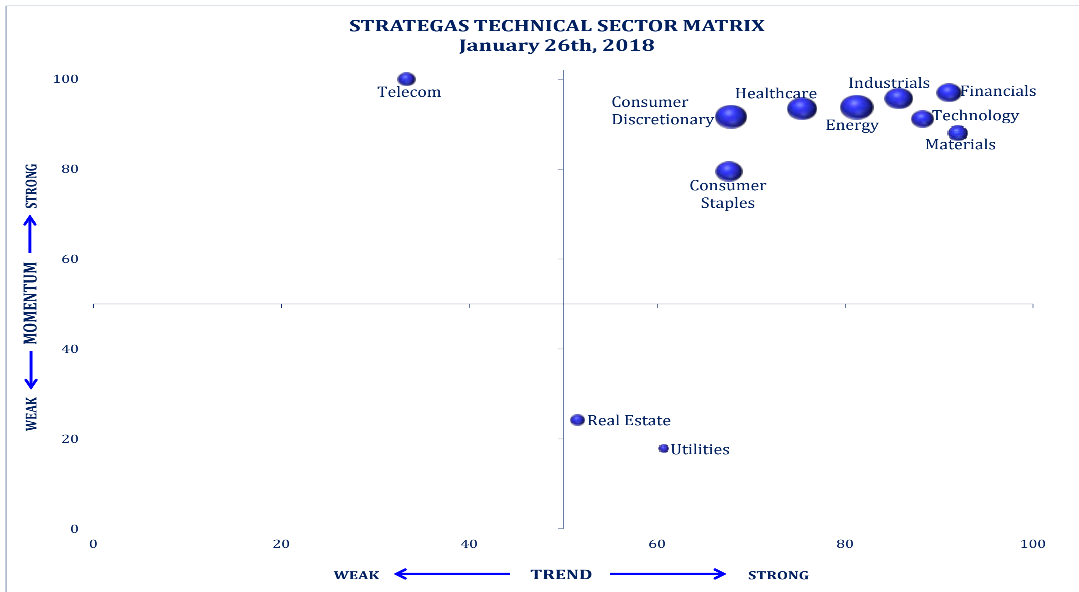
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2018 Bloomberg Finance L.P.
SN 713017 EST GMT-5:00 G594-3311-0 09-Mar-2018 13:32:12

Source: Bloomberg

2) The underlying market composition of the S&P 500 is generally healthy

The underlying composition of the U.S. equity market is healthy in our assessment in the fact that the sectors which you want to lead a bull market are actually leading! This leadership group includes financials, technology, industrials, and selected consumer and healthcare names. These are the sustainable sectors to continue to lead a bull advance. Ex: You don't really want energy and staples and utilities leading a bull market advance as there are limits to which these sectors can take you. In other words, we currently have the right offensive leadership within the equity marketplace.

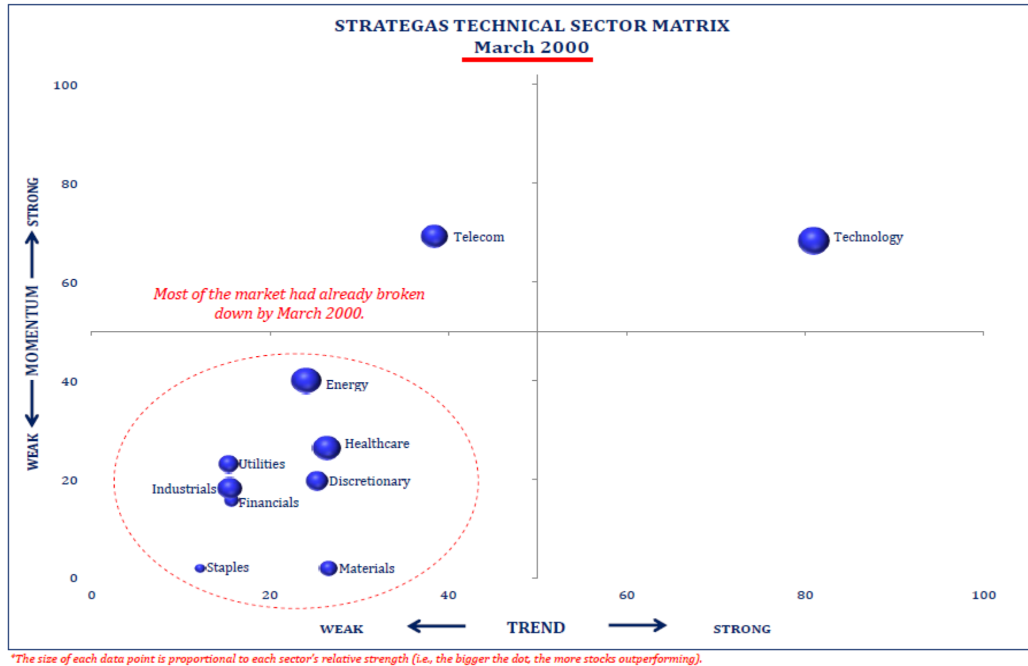
Exhibit 2: Current Market Composition Matrix of the S&P 500



Source: Strategas

Exhibit 3: Versus Unhealthy Market Composition at 2000 Top

SECTOR MATRIX IN 2000 = NARROW



Source: Strategas

3) Technological innovations continue to enhance productivity and keep inflation in check

Technology has continued to play a critical role in enhancing productivity of the workforce and preventing profit margins from heading south. This seems likely to continue as we look forward to advancements in artificial intelligence, potential for driverless cars, robotics and automation, the connected home, and 5g infrastructure supporting machine to machine learning and communication (a.k.a "The Internet of Things"). This ingenuity of the American workforce is truly second to none and as soon as you think we have hit an innovation ceiling, something else comes along! This is the cornerstone of the American capitalistic economic system and what has positively separated us over time. This is set to continue.

Ex: Ring was recently sold to Amazon for $1 billion after being turned down on the Shark Tank. American ingenuity is alive and well and being rewarded!

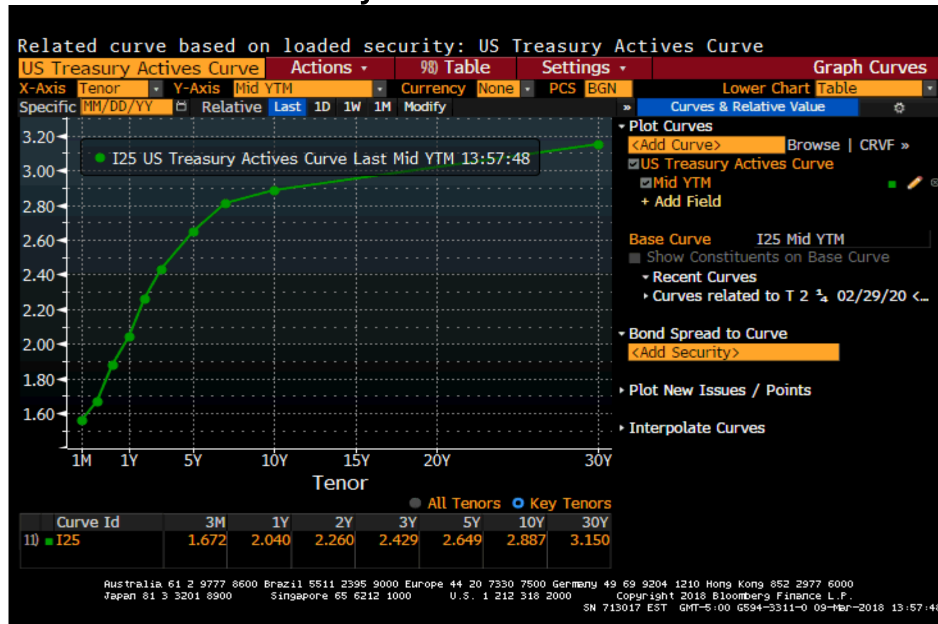
Ex: 3D printing technology now allows a small house to be constructed using the technology in less than a day

4) Yield curve is positively sloped

A positively sloped yield curve indicates a certain level of health of the economy and the way things are ideally supposed to function. A positively sloped yield curve indicates bond investors expect a certain level of growth and inflation over

time and expect to be compensated at appropriately higher levels for the risk associated with locking money up for a longer period of time.

Exhibit 4: Current U.S. Treasury Yield Curve



Source: Bloomberg

5) Fed is tightening

This observation is not necessarily a positive for U.S. equities, but is not a negative at this point either. What it does indicate is that we are likely in the second half of the bull market which started nine years ago at the bottom in 2009, but it doesn't necessarily mean that we are in the 9th inning either. The bull market is maturing if you will. The exhibit below is a really good one provided by Ed Hyman at Evercore ISI and is one we should all keep on our minds are we navigate the maturing business cycle dance as he calls it.

Exhibit 5: The Typical Maturing Business Cycle Dance

Here We Go,
Economy Good,
Rates Go Up,
Earnings Go Up,
Rates Go Up,
Economy Better,
Rates Go Up,
Economy Great,
Rates Go Up,
NEW ERA THINKING!
Yield Curve Inverts
No Problem!
Bear Market Starts

Source: ISI

6) Tax cuts are in the books – We now have certainty for boards as they plan capital structure and M&A decisions

Not only do the tax cuts enable corporations to keep more of what they earn, but they importantly provide certainty for board level decisions moving forward. We expect this certainty to lead to a healthy level of capital market activity in 2018 including an increasing level of mergers and acquisitions, continued share repurchases, and the potential for special and increased dividend levels. Increased certainty combined with shareholder friendly capital decisions moving forward should be a big positive for equities.

On the M&A front, we have seen several large public/public M&A transactions announced subsequent to the passing of the tax bill including Cigna buying Express Scripts and Microchip buying Microsemi. We expect to see more of this corporate activity moving forward over the remainder of the year.

7) Wages are finally rising

The tight job market combined with the recent tax cut has led to green shoots for wages. Following the tax cut announcement, many corporations have raised their minimum wages (some as high as $15/hour for large banks) and have also announced bonuses across the board attributed to the corporate tax cut. While labor pressure is not necessarily a positive sign for corporate margins, more money in the hands of consumers is not necessarily a bad thing for an economy largely driven by consumption (over 70% of GDP).

8) Infrastructure spending is a wildcard for 2018

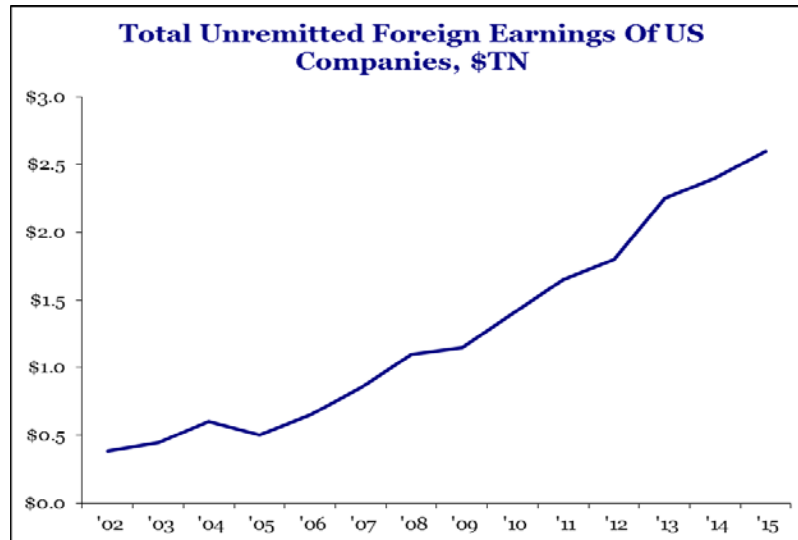
Trump's economic agenda is largely based on reflation. In addition to reflating the economy, he is a builder at heart and by trade. This fact meets America's growing infrastructure needs and we have a potential formula for a bipartisan infrastructure bill. This would obviously be stimulative to employment, wages, and would benefit many industrial and materials companies as demand could increase substantially. This is something we are keeping an eye on as we monitor what is coming out of Washington D.C. for the remainder of 2018.

9) Repatriation is a tailwind for stocks

Repatriation is likely to be stimulative as companies take advantage of the recently passed tax law to bring overseas cash home starting in earnest this year. As an example of this, Apple has committed to spending $350 billion in the U.S. over the

coming years as a result of the tax change. This repatriation should serve as somewhat of another QE for U.S. companies and the U.S. economy.

Exhibit 6: Potential Foreign Earnings Repatriation



Source: Strategas

10) Borrowing rates are rising and we continue to run government deficits…..Could there be more risk in the bond market than the stock market?

The U.S. government continues to run fairly sizeable budget deficits and borrowing rates are on the rise. Could this eventually be a risk for equity markets? It is obviously a risk for bond markets. Are the bond vigilantes back to spoil the day? We were recently in an investment meeting and one of the presenters mentioned a stat that 95% of the CFA Charterholders received their charter post 1982 and thus in a bond bull market. Dr. Bronner might be the only one on our investment staff to have worked in the face of a steadily rising rate environment as he did during the first 8 years of his tenure at the RSA. That makes for an interesting investing backdrop given bond market yields have broken their downward trendline over a 35 year time frame.

11) Tarriffs/protectionist sentiment is a risk

We obviously don't need a modern day Smoot Hawley tariff to lead to trade wars. We will just have to wait and see the ramifications of us imposing a 25% tariff on steel imports and a 10% tariff on aluminum imports. We have written many times about the need for the U.S. and China to rebalance and cooperate moving forward as the two largest economies on the global stage. In an ideal world, our trade deficit could be solved by opening up the large potential consumer demand in China to American brands.

Cryptocurrencies Gone Wild!

What would a conversation about markets be about today without at least mentioning the cryptocurrency craze? We are frankly not quite sure what to make of it other than seems like a byproduct of loose global monetary policy for an extended period of time. We don't necessarily see it as indicating a complete speculative frenzy across the investing board. That being said, the collective paper market cap of the crypto world is quite large and warrants monitoring and certainly has elements of an investment bubble. According to coinmarketcap.com, there are currently 1,565 cryptocurrencies with a collective market cap of $326.4 billion dollars!

Exhibit 7: Snapshot of the 5 Largest Cryptocurrencies (as of 3/19/18)

1) Bitcoin - $145 billion market cap (circulating supply of 16,928,112)

2) Ethereum - $54 billion market cap (circulating supply of 98,284,884)

3) Ripple - $26 billion market cap (circulating supply of 39,091,716,516)

4) Bitcoin Cash - $17 billion market cap (circulating supply of 17,026,188)

5) Litecoin - $9 billion market cap (circulating supply of 55,697,206)

Source: Coinmarketcap.com

Equity Strategy Moving Forward

We think that we are in a maturing bull market that admittedly does have some risk associated with it, but that there is enough general health and breadth to the market combined with several tailwinds moving forward to provide for the strong potential for further equity upside combined with buffered downside risk. We have layered put spread collar protection on a portion of the equity portfolio as the markets have risen to help protect against the risk of a pullback and will continue to tactically look for opportunities to protect some gains moving forward. In the same light that anyone who is reading this and has purchased life insurance has underperformed their financial life, protection does have a cost in a bull market. We have decided the best way to fund the cost is by selling calls well north of our actuarial rate of return. This creates somewhat of a win/win scenario on an absolute basis relative to our investment objectives.

We have mentioned many of the current risks to the marketplace in recent write-ups including a pickup in inflation causing multiple and margin contraction, trade wars, the fact that we are now entering the 10th year of a bull market advance and any other unknowns. We will continue to evaluate the risk situation on a daily basis as we manage your money!

International Equity Strategy

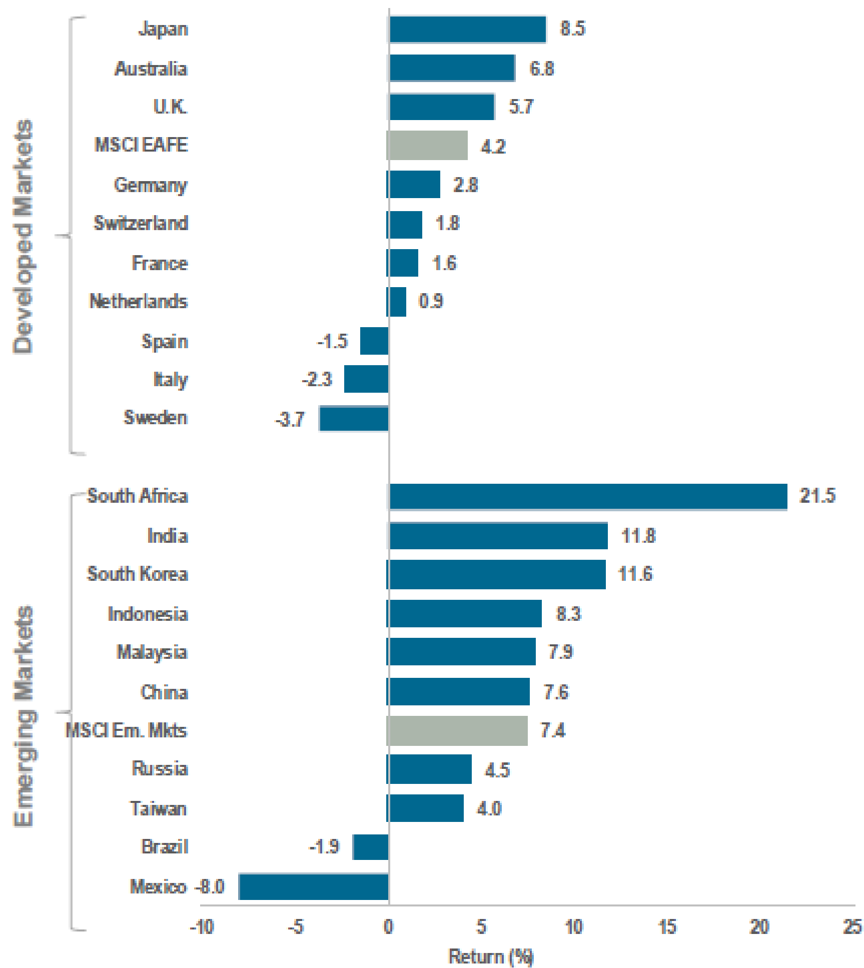
By Steve Lambdin

The resiliency of the international equity markets continued in the fourth quarter of 2017 as investors remained hungry for risk assets in the period. Many of these markets finished 2017 at or near record high territory. The combination of accelerating economic forecasts, strong corporate earnings, higher business and consumer confidence, contained inflation, and major central bank stability seemed to be the right recipe for higher equity markets. Nearly all of the world's major economies are now in economic expansion for the first time in ten years. The U.S. dollar continued to follow its recent falling trend and helped unhedged investors nearly +.5% in the period. European economic activity continued to impress investors as the European Commission continued to lift growth expectations for the region. Job growth across the Eurozone is at its fastest pace in over 15 years. Even Brexit news was positive in the quarter as progress has been made on the first set of issues confronting each other. The Japanese equity market was on "fire" in the quarter as business conditions continue to improve as well as Abe's victory in the recent elections. With this victory, many see Abe's chances to further reforms to spur growth as significantly enhanced, which should be good for the region. Xi Jinping was re-elected Communist Party Secretary General in China which was relatively welcomed by investors and helped push equity markets higher in the quarter. This kept emerging market equities as a popular vehicle for investors to put on more risk in a solid economic climate. About the only negatives in the period was the continued rising tensions on the Korean peninsula as well as the continued problems in Syria. Beyond these geo-political risks, we would say the global economy has picked up even more steam from just a few months ago and looks very solid in early 2018.

Market(s)	MSCI Index	4Q17	1 Year	3 Years	5 Years
All Developed and Emerging	ACWI	5.73	23.97	9.30	10.80
Developed	World	5.51	22.40	9.26	11.64
Emerging	EM	7.44	37.28	9.10	4.35
Developed (ex USA)	EAFE	4.23	25.03	7.80	7.90
Developed and Emerging (ex USA)	ACWI ex USA	5.00	27.19	7.83	6.80
United States	USA	6.40	21.19	10.61	14.98
Japan	Japan	8.49	23.99	11.62	11.16
United Kingdom	UK	5.72	22.30	4.14	5.21
Germany	Germany	2.78	27.70	8.78	8.68
France	France	1.50	28.75	10.49	8.95
China	China	7.62	54.07	12.74	9.90
India	India	11.82	38.76	8.69	8.87

Source: Aristotle Int'l Fund Commentary and Factset

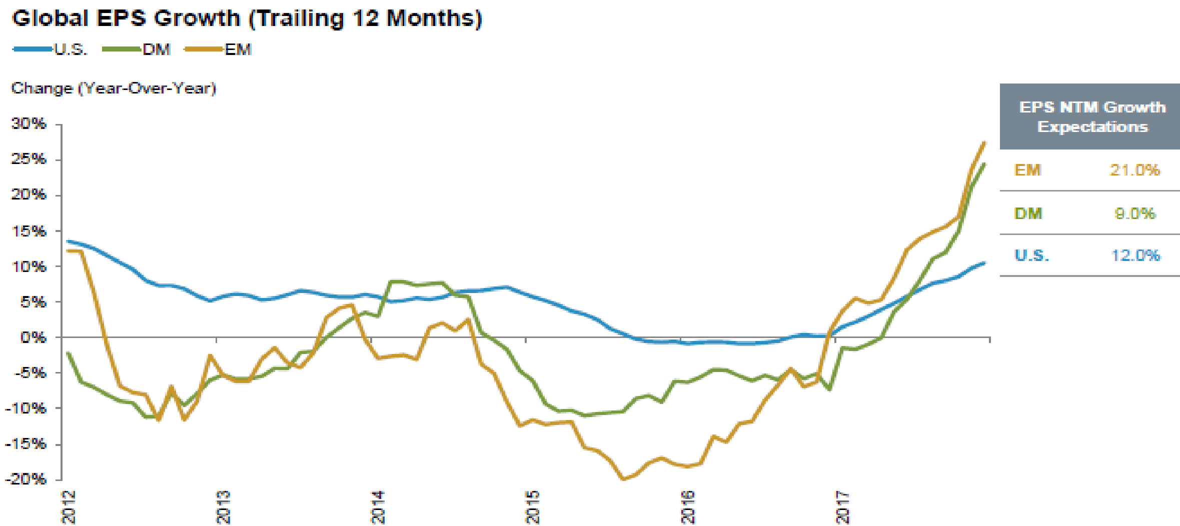
The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +4.2% and +7.4% respectively during the fourth quarter of 2017 vs. +6.6% for the S&P 500 Index. This was the first time this year that U.S. stocks outperformed large cap international stocks. However, for 2017 as a whole, global equities were stronger than the S&P 500 index, especially emerging market equities. The U.S. dollar continued to fall in the fourth quarter and provided a slight benefit for unhedged U.S. investors as mentioned earlier. The Pacific region was significantly stronger than the European region, as the Japanese equity market was up significantly in the period. From an economic sector standpoint, the cyclical sectors were very good in the fourth quarter, while the defensive sectors of Healthcare and Utilities were weak. Commodities were generally higher in the period as crude oil rose +16% and copper rose nearly +12%, which remains consistent with a growing global economy.



Source: Baird Market Chartbook; Morningstar Direct; MSCI

So far into the first quarter of 2018, global equities look like a roller coaster as a multitude of issues have come into play. Most markets started the year by hitting new highs in mid to late January as Trump's massive tax overhaul plan began to be implemented with sweeping changes to U.S. corporate and individual tax policies. This was well received by investors around the globe and was a key catalyst cited in keeping the global economy moving in the right direction. However, this early 2018 rally gave way to a massive trade tariff on imported steel and aluminum being implemented by Trump in an effort to cut the U.S. trade deficit with a large portion of the world. This threatens the ongoing global expansion with a potential trade war and investors sold equities down significantly in early to mid-February. Since this time, international equities have rallied back to where we were at to start the year, with the exception being emerging markets, which have managed to hold onto some levels of gains this year up to this point. At this time, it's anyone guess what the ultimate outcome of these actions and responses will be. We are hoping this can simmer down in the coming weeks and months and not threaten the global expansion we all have to come to witness. Most global business fundamentals still look very solid. Through all

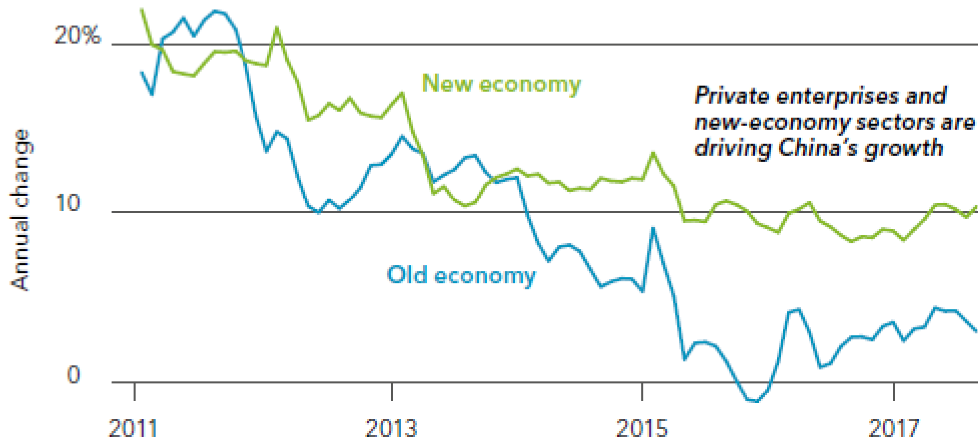
of this so far in 2018, the MSCI EAFE Index is about flat and the MSCI Emerging Markets Index is up approximately +5% through mid-March, vs. +3% for the S&P 500 Index. Things certainly seem tense at the moment.



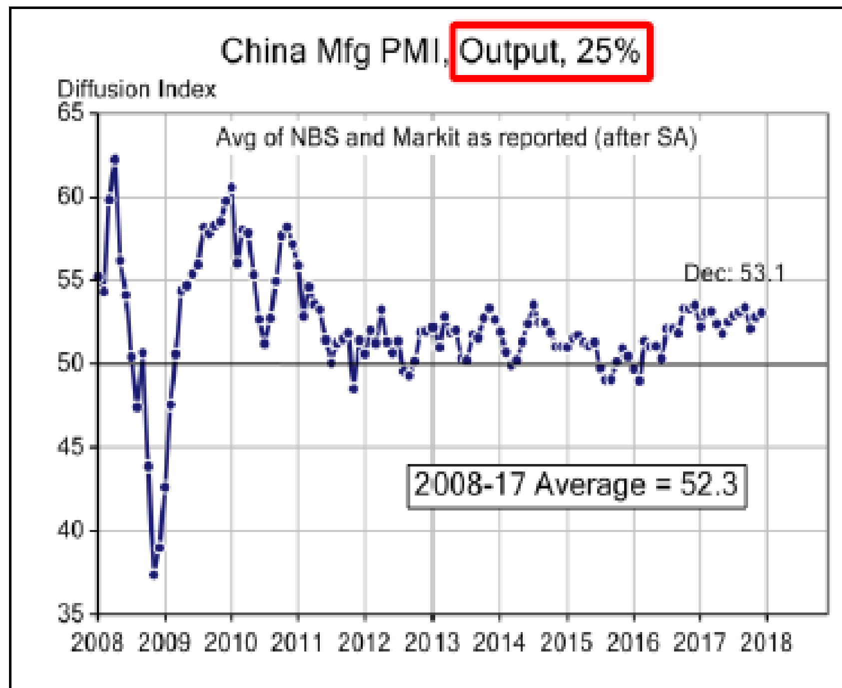
Source: Fidelity 2018 Market Update; Factset; MSCI

Asia Update

The Asian equity markets continued to grind higher in the fourth quarter as the MSCI Pacific region rose +8.0% as investors were very comfortable with the region as increasing business and consumer confidence was well received. Local and currency adjusted returns were about in line with one another in the quarter. As has been the case lately, the Japanese equity market was the top performing market and rose +8.5% in the period on the strength of solid corporate earnings and an extension of the longest economic growth streak in over 15 years. Most countries in the Asian basin also saw good strength in their respective equity markets. Chinese equities also continued to participate, rising +7.6% in the quarter as investors remained positive toward the leadership here as they embrace slower, but more balanced growth in the region. The Asian region continues to impress most investors and the equity markets have certainly responded accordingly.

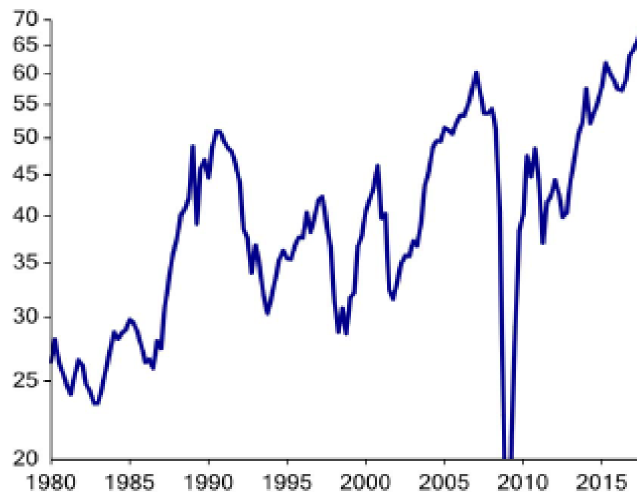


The Chinese economy continued to be very steady as fourth quarter GDP rose +6.8% from a year earlier, which wound up being the same from the previous quarter. For all of 2017, GDP grew +6.9%, which was a slight acceleration from 2016. We were actually a bit surprised by this. Xi Jinping's re-election as Secretary General should pave the way for continued reforms here and probably even an acceleration of reforms. We view this a major positive for this region. Industrial production was steady in late 2017 as December rose +6.2% from a year earlier, which is about the same pace of the previous few months. For all of 2017, industrial production rose +6.6%, which we view as decent in today's climate. Fixed asset growth was fairly steady and rose +7.2% from a year earlier in December, which is the same level for the YTD as well. Exports were a little bit up and down during the fourth quarter, but December's exports grew +10.9% from a year earlier, to finish on a positive note for the year. We would expect this data point to be volatile going forward as a potential trade war with the U.S. could be looming. But beyond this, most of China's Asian trading partners have a robust outlook at the moment. Retail sales growth in December was the weakest of the year at +9.2% year over year, but was still up +10.2% for all of 2017. We would expect this data point to improve in early 2018. Inflation remained not much of an issue in late 2017 as December consumer prices rose +1.8% from the year earlier period. This key statistic remains well below the government's targeted rate. Looking out into early/mid 2018, the key issue is what will be China's response to the recent tariff's being imposed by the Trump administration. We expect this to be a delicate slippery road to navigate over the near term, with many possible outcomes, many of which will be quite negative. Investors should remain watchful for developments on this front. Beyond this, we still see a very stable economy in China at present with a small level of upside potential over the next few months.



Source: Evercore ISI

The economy in Japan continued to surprise investors to the upside in the fourth quarter, as GDP grew +.4% from the previous quarter, or +1.6% from the year earlier period. This now makes the 8th quarter of growth in a row and is now the longest period of expansion in over 16 years. We find this quite remarkable that this has unfolded over the last couple of years. Corporate earnings and business confidence are shining in this economy at the moment. Exports remain a key component to the recovery here as exchange rates are a nice tailwind to trade. With Prime Minister Shinzo Abe's recent victory in the parliament election now behind him, we see a further push toward even more reforms in an effort to keep the economic growth engine running here. As expected, the Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0% at its recent meetings. Its massive monetary stimulus continues to remain in place, especially as a potential trade war presents a risk for this economy. Industrial production remained very healthy in the fourth quarter, as December was up +4.4% from a year earlier. As mentioned earlier, currency movements are providing a nice shot in the arm for manufacturers that export. Consumer confidence continued to move higher in late 2017 as December's reading of 44.7 remained near the highest levels in almost five years. Core prices are still moving higher in Japan as December prices rose +.9% from a year earlier, which is moving in the right direction for government officials. The labor market remains very tight as the jobless rate fell to 2.4% in January while the jobs-to-applicant ratio stayed at 1.59. The labor participation rate still remains above 60% here, which should put pressure on wage gains at some point. No doubt, the good news on the economic front translated into a good equity market in the fourth quarter.



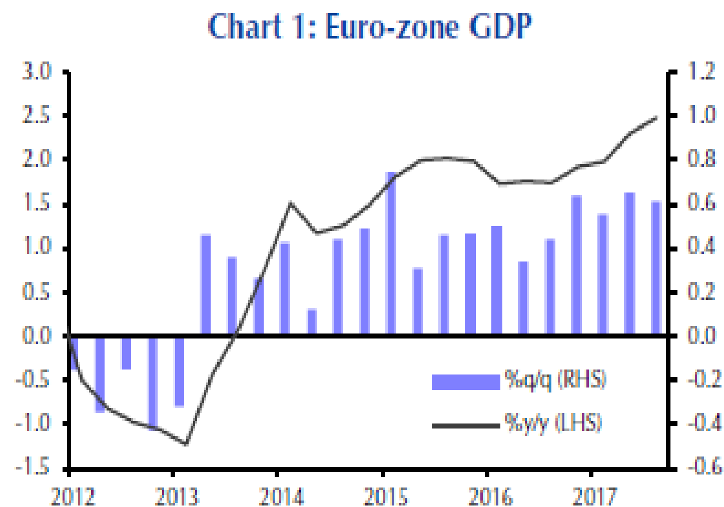
Source: Evercore ISI

Europe Update

European equities continued to move upward in the fourth quarter as the Eurozone economy continued to enjoy its fastest pace of economic expansion in six years as pro-growth measures have accelerated the economic outlook of this region. Corporate profits are on a tear while job creation is at the fastest pace in quite some time. This continued to give investors comfort toward this region and pushed the MSCI European Index (ex. U.K.) up +1.0% in the quarter, with most of this return from the movement of the currency. The German equity market provided the bulk of the return in the period as this market rose +2.8% on the heels of robust economic data points, especially with regard to exports late in the year. As was the case in the previous quarter, the higher beta more cyclical sectors of the market provided most of the return as investors continued to layer on more risk in the region. At its recent meeting, The European Central Bank (ECB) continued to maintain its key interest rate levels but dropped its easing bias. Asset purchase targets were reduced going forward with a curtailment expected in late summer or early fall of this year. However, even as this unfolds, we still expect interest rates to remain fairly well contained in the region.

The European economy continued to expand in the fourth quarter as GDP climbed another +.6% from the previous quarter, or +2.7% from the year earlier period. For all of 2017, GDP grew +2.5%, which is the fastest pace since the great recession. The region actually looks to have accelerated in the second half of 2017, which has surprised most of us. The Dutch, Spanish, German, and French economies provided the bulk of the strength for this region in the quarter. Industrial production continued to move ahead, rising +5.2% in December from a year earlier, which the fastest pace of

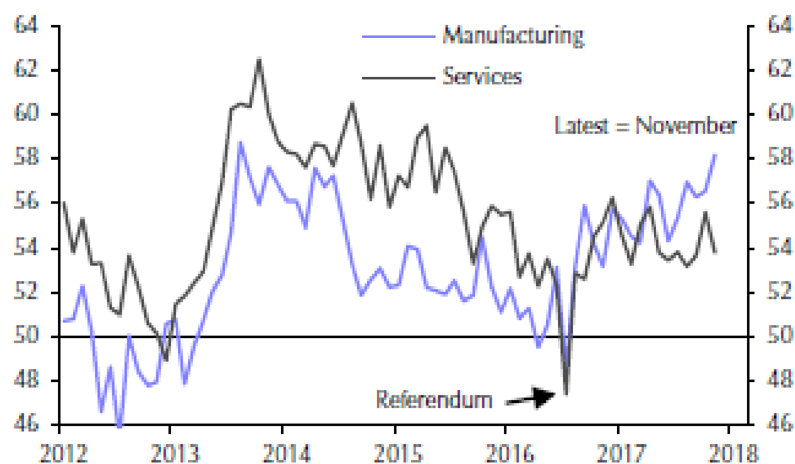
the year. The German production has been flat-out impressive, as exports rose +20% in December. The index of executive and consumer sentiment continued to climb and rose to 116 in December, which is the highest level since 2000. This key statistic seems to have clear momentum now and sets up nice for 2018. Retail sales have been a bit of a mixed bag lately, but December's sales were reported to be up +1.9% from the previous year, but a bit cooler from November. We would not read too much into this as this data point can be very lumpy from month to month. Most expect this to pick up a bit from current levels as we move through the next several months. The CPI remained very steady in late 2017 as December Core CPI rose only +.9% from a year earlier, remaining at the slowest pace of 2017. We would expect this to rise a bit going forward as the economy gains momentum, but not to a point where it becomes much of an issue. The unemployment rate continued to fall in late 2017 as December unemployment fell to 8.7%, the lowest rate since the great recession. As we digest these data points in the Eurozone economy, this region seems firm and moving in the right direction. With any luck, economic growth in 2018 could climb to yet new heights from the disaster scenario of ten years ago. This could push the equity markets higher as this unfolds.



Source: Capital Economics

U.K. equities posted some very solid gains in the fourth quarter as the MSCI U.K. Index returned +5.7%. Some surprising news on factory output as well as progress on the Brexit negotiations gave some comfort to equity investors and served as a catalyst to push markets higher. No doubt, Brexit news flow will dominate most investors' minds going forward and we would expect the markets to take the lead from this. Perhaps this can go a bit better than many expect and be a positive point for the markets. We will watch and see. The economy still seemed steady in late 2017, as GDP grew by +.4% in the fourth quarter from the previous quarter, or +1.5% from the year earlier period. Growth remains slow, but yet consistent lately. Consumer spending and business investment seem to be the weaker links, but factory output was stronger than most anticipated. This resulted in a strong export climate late in the year. Industrial production struggled in the quarter and grew only +.5% from the

previous year. The mining and oil&gas sectors were very weak in December, putting pressure on overall industrial production. In a measure of the consumer, retail sales continued the recent weak trend and were only up +.3% in the fourth quarter as heavy discounting continued during the holiday season and was tough to overcome. Core CPI cooled just a bit as December's reading of +2.5% from a year earlier is still above the Bank of England's (BOE) targeted rate. The BOE expects Core CPI to trend downward as we move through 2018. At its recent February meeting, the Monetary Policy Committee (MPC) held its benchmark interest rate steady at .50%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. At this point, we do not expect another interest rate increase until maybe mid to late 2018. Of course, this will be data driven. The employment situation remained steady as the fourth quarter unemployment rate was reported at 4.4%, which is just a slight uptick from 40 year lows. Employment actually slipped just slightly, but ending employment remained near a record at 32.1 million workers. Wage growth was a little better as wages grew by +2.5% in December, but still remains rather anemic.

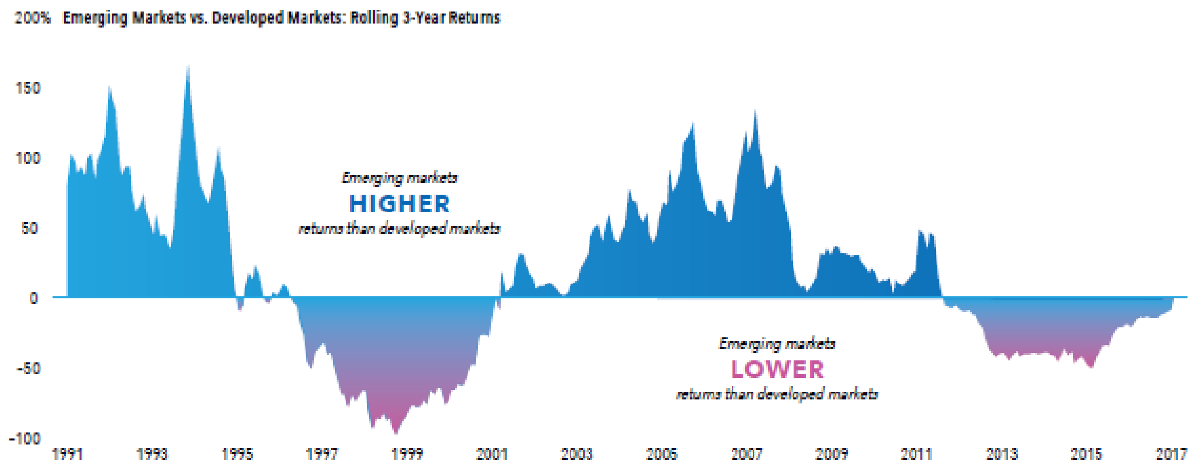


Source: Capital Economics

Emerging Markets

The rally that began in emerging market equities back in early 2016 is now almost 22 months long and we still believe we are heading higher as long as the current global economic environment holds. The MSCI Emerging Markets Index was up +7.4% in the fourth quarter, +37.3% for all of 2017, and +13% already in our current fiscal year. These results continue to be quite stellar. The expanding global economy, U.S. dollar

weakness, and modest valuations are a nice recipe to even further gains. Commodity price gains are helping the resource dependent countries while the rally in global technology shares are pushing the technology heavy regions. This has all led to significant earnings growth expectations as well as robust cash flows in most of these countries. Even reforms in India and China are helping the picture here as well. Perhaps even the geo-political front can help here if progress is made from the upcoming joint talks with North Korea. With all of these issues in mind, we continue to have a positive near and long term view toward emerging market equities as do most investors at this time.



Source: Capital Group 2018 Outlook

International Equity Activity/Strategy

Even with all of the rhetoric surrounding U.S. trade tariffs and the possibility of this igniting a trade war with China and other parts of the world and the volatility this has brought to the equity markets lately, we are still very optimistic with regards toward the global growth story unfolding before us. Growth projections are actually accelerating in many parts of the world and this provides for a nice backdrop for the global equity markets. Central banks are proceeding with caution, inflation still seems rather tame, interest rates are manageable, employment trends are growing, and corporate earnings growth is robust, which still seems to us to provide an environment for further gains in global equities. Equity valuations are not quite as extended as they have been in the near past, which is yet another positive to point to in this market climate. Also, the latest news on the Brexit front seems to be getting just a bit more positive than a few months back. Even things on the geo-political front could be warming up a bit, as leaders from North Korea, South Korea, and the U.S. will be conducting a historic meeting sometime over the next few months to discuss a potential change with North Korea's nuclear program. Of course, this can take many twists and turns and could go in a different direction. But this seems good at least on the margin. With all

of this in mind, we could easily see higher global equity markets over the next few months.

After adding to our emerging markets exposure in the first quarter of our fiscal year, we have been a little quiet lately on this front. We did recently sell approximately $48.5 million of our EEM in mid-January just to take some quick profits from the strength of this in the early part of our fiscal year. We will attempt to add this and perhaps more back to the emerging markets portfolio as volatility presents us a decent opportunity going forward. We still see this as one area where multi-year gains could lie ahead. We also have remained very active with our put writing on EEM over the last few months and expect to continue to be going forward in an effort to add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 3.0% of total assets and approximately 11.2% for MSCI EAFE equities. *(Credit is given to the following entities for charts provided: Capital Economics, Capital Group 2018 Outlook, European Commission, Haver Analytics, Blackrock Investment Institute, Bloomberg, MSCI, Thomson Reuters, Baird Market Chartbook, Aristotle Int'l Fund, Fidelity Investments, Factset, Evercore ISI, and Morningstar Direct)*