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Fourth Quarter Market Watch

2017 was yet another banner year for the US equity market, defying the predictions among Wall Street analysts set at the beginning of the year. The S&P 500 hit record highs 53 times and surged 21.3%, more than triple some strategists' projections in 2017. The Dow Jones Industrial Average delivered an even stronger 27.7% return, notching 70 record closes in 2017. The Nasdaq has risen faster than any other US index over the past year, returning 28.5%. Such strong gains were powered by a corporate earnings recovery, synchronized global economic growth, and still-supportive monetary policy.

Economic growth has picked up around the world, oil pricing has rebounded from its bear market and the US dollar has weakened, with the latter particularly beneficial to earnings at many large multinational corporations in the US. Though the Federal Reserve has raised interest rates, it has done so at a gradual pace, providing an additional boon to the stock market. This backdrop helped the stock market snap back from occasional pullbacks in 2017. The S&P 500 has gone 66 weeks without a 2% weekly drop, its longest stretch since 1965. Meanwhile, the CBOE Volatility Index has plumbed record lows for much of the year.

2017 underscores a year of a drastically reshaped US political landscape. The newly sworn-in President Trump entered office with six big initiatives: repeal and replace President Obama's health-care act, renegotiate traditional trade agreements, pass a corporate tax reform, reduce regulations, rebuild America's aged infrastructure, and appoint a wave of conservative judges. Defying the policy skepticism that prevailed throughout the year, President Trump succeeded in reaching a historic, $1.5 trillion tax overhaul in December. Effective January 1st, 2018, the US corporate tax rate is reduced from 35% to 21%. The new tax codes will also result limit deductions that individuals may take on state and local taxes. But so far, the rest of President Trump's administration record has been mixed. The administration failed to replace Obamacare. Meanwhile, the new funding for infrastructure has struggled with budget deficits.

Such political under-currents have broad implications on various segments of the markets and industries. For example, for much of 2017, bank shares struggled to build on their postelection gains when the passage of tax-code changes seemed questionable. But the tide quickly changed and investors have become more optimistic when lawmakers passed the tax reform. Banks in the US typically pay relatively high tax rates so they are expected to benefit from the planned reduction in tax rates. Meanwhile, banks welcome the end of tough regulatory scrutiny, which had led to higher compliance costs and major fines.

On the geopolitical front, some note-worthy developments include North Korea's heightened tensions with neighboring countries and the US by launching its intercontinental ballistic missile. German Chancellor Angela Merkel failed to form a coalition government, throwing the leadership and direction of Europe's largest economy into doubt. British Prime Minister Theresa May faces a series of hurdles as she negotiates Brexit from the EU. Notably, neither the policy uncertainty in the US nor the geopolitical tensions deterred the strong financial market returns in 2017.

Turing to the oil market, crude oil prices stabilized in 2017 and more recently began to climb, mostly due to OPEC's production cuts, synchronized global economic growth, and rising geopolitical tensions

	Date	1 Quarter Ago		1 Year Ago	
	12/31/2017	9/30/2017	% chg	12/31/2016	% chg
DJIA	24,719.22	22,405.09	11.0%	24,719.22	27.7%
S&P 500	2,673.61	2,519.36	6.6%	2,673.61	21.3%
NASDAQ Composite	6,903.39	6,495.96	6.5%	6,903.39	28.5%
Russell 2000	3,816.13	3,705.17	3.3%	3,816.13	14.1%

	Date	1 Quarter Ago		1 Year Ago	
	12/31/2017	9/30/2017	% chg	12/30/2016	% chg
Japan Nikkei 225	22,764.94	20,356.28	11.7%	22,764.94	19.6%
MSCI EM (Emerging Markets)	1,158.45	1,081.72	7.5%	60,878.90	38.4%
MSCI EAFE	2,050.79	1,973.81	4.3%	2,050.79	26.3%
MSCI AC World	513.03	486.88	5.8%	513.03	24.6%
FTSE 100	6,519.85	6,207.92	5.9%	6,519.85	21.1%
SSE Composite Index	3,307.17	3,348.94	0.7%	3,307.17	10.4%

US Equity Sector

	Q4	1-yr ret.
Consumer Discretionary	9.9%	18.8%
Consumer Staples	6.5%	11.3%
Energy	6.0%	2.9%
Financials	8.6%	20.3%
Health Care	1.5%	17.7%
Industrials	6.1%	18.8%
Information Tech	9.0%	30.8%
Materials	6.9%	18.4%
Telecom	3.6%	3.7%
Utilities	0.2%	11.6%

US Equity Style

	Q4	1-yr ret.
Russell 1000 Value	5.3%	12.2%
Russell 1000 Growth	7.9%	25.1%
Russell 2000 Value	2.0%	8.2%
Russell 2000 Growth	4.6%	19.8%

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that interrupted oil supplies. US crude oil ended 2017 at $60.42, gaining 12% for the year and the international price finished at $66.87, up an even stronger 18% from a year ago. Looking into 2018, many expect a rocky path for higher oil prices, supported by a growing global economy and OPEC-led production cuts, offset by booming supplies from the US.

Mergers and acquisitions slowed during the fourth quarter, as US policy uncertainty crimped corporate appetite for deals. However, the tide quickly turned. The tax policy uncertainty that temporarily kept corporations on the sidelines has become a big positive for prospective sellers. A cut in the corporate tax rate from 35% to 21% will reduce the tax bill to potential sellers. A repatriation tax holiday will likely add more fire power to acquisitions. The current environment presents a fertile for companies to pursue deal making, with a record level of cash at their disposal, and the cost of debt at still historically low levels. Further, companies in health care, media and technology industries are becoming more active to expand scale so as to fend off competition.

At the start of 2017, a group of 18 Wall Street strategists expected the S&P 500 would rise 5.5% for the year, on average. Instead, the index has risen more than 21%. US stocks already trade at historically high levels, yet the fresh records in the US stock markets at the end of the year further increased enthusiasm among investors into 2018. Historically, individual investors have chased stocks with more fervor near the end of a bull market, ignoring economic and financial metrics. One of the metrics worth noting is a flattening yield curve, indicated by a rise in short-term treasury yields relative to long-term ones. A flattening yield curve often indicates a slowing economy. Looking ahead, there are a few economic and financial factors that could detract market returns, including monetary tightening factors and the US dollar performance. A faster-than-expected Fed tightening could hurt the US bond market; a potentially resulting stronger dollar would likely hurt emerging-market assets.

Early February 2018, the 1,100 point decline in the Dow came just six trading days after its best-ever start to a year. While the velocity of the market reversal is meaningful, the exact causes are indeterminate, this turbulence seen in the year to date gives us flashbacks of the beginning of 2017, when many investors had begun early exists from the US equity markets, were only to be caught by surprise how relentlessly the markets had continued to rally subsequently, despite this past week's sharp decline.

What should be done? we have been cautious about some of the economic indicators and historically high valuations for some time and continue to take a disciplined approach to asset allocation and security selection. Despite the sharp market decline early this week, global economic growth continues and world's central banks remain accommodative. Additionally, the recent sell-off suggests that investor optimism has not yet turned into euphoria. This is because major professional asset managers have mostly remained cautious as they did at the beginning of 2017. Also, individual investors have not been aggressively using margin debt against their brokerage accounts as they did during the previous market peaks. This left us to believe that an imminent recession is unlikely in the near future, but remaining on guard for an inevitable valuation-driven reversal.

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Bond Markets

	12/31/2016	1 Qtr Ago	1 Yr. Ago
Treasury Bill, 90 Day	0.50	0.27	0.17
Treasury Note, 2 Year	1.20	0.76	1.06
Treasury Note, 5 Year	1.92	1.15	1.76
Treasury Bond, 10 Year	2.44	1.60	2.27
Treasury Bond, 30 Year	3.07	2.32	3.02

US Bond Sector Performance

	Q4	YTD	1-Year Return
BAR CAP Govt. Interm. TR	-2.2%	0.0%	1.2%

Exchange Rates (Rate per US dollar)

	12/31/15	1 Qtr Ago	1 Year Ago
Canadian Dollar	1.253	1.251	1.341
Mexican New Peso	19.566	18.159	20.602
Euro	0.833	0.846	0.948
British Pound	0.739	0.745	0.809
Swiss Franc	0.975	0.968	1.016
Chinese Yuan	6.512	6.643	6.950
Indian Rupee	63.828	65.320	67.870
Japanese Yen	112.650	112.565	116.635

Commodities (In US dollars)

	12/31/2017	1 Qtr Ago	1 Yr. Ago
Gold	1,277.30	1,151.70	1,320.60
Crude Oil	50.65	53.72	48.33
UD Dollar Index	93.36	102.29	96.20
Bloomberg Commodity Index	84.46	87.51	88.84

Interest Rates

	12/31/2017	1 Qtr Ago	1 Yr. Ago
PRIME RATE	4.50	4.25	3.75
FEDERAL FUNDS RATE	1.43	1.16	0.66
LIBOR RATE 30 DAY	0.16	0.16	0.16
LIBOR RATE 3 MONTHS	0.23	0.23	0.23
30YR FIXED MORTGAGE	3.99	3.83	4.32

Economic Sentiment

	12/31/2017	1 Yr. Ago
Unemployment Rate	4.10	4.90
Average Single Family Home	288,600	291,300
Capacity Utilization	77.90	75.80