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WEALTH ADVISORS

MARKET AND ECONOMIC OUTLOOK

January 2018

Tax Information

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Optimism Prevails for 2017, With Bullish New Year Boost from Tax Reform

2017 was an auspicious year for investors. U.S. publicly traded stocks, led by gains in technology shares, not only provided strong returns, but they did so with remarkably low levels of volatility. Meanwhile, non-U.S. stocks added value to a diversified portfolio by posting higher returns than the domestic issues. The broad economic backdrop remains mostly positive, and major tax reform — passed just before year-end — may spur even more optimism. In this issue of *Market and Economic Outlook* we look back at 2017 and examine factors that may help shape the coming year in the capital markets.

Positives	Negatives
Employment is strong	Future returns (for the next 7 – 10 years) from stocks and bonds are expected to be lower than long-term historical averages
Housing market is firm	Geopolitical risks, e.g., North Korea; terrorism
Risk of recession in the United States appears low, near term	Policy uncertainty in the United States, specifically around trade and health care
Consumer and small business confidence is high	
U.S. corporate earnings forecast is positive	

Third Quarter and Year-to-Date 2017 Index Returns (%)

Index Name	Capital Market Segment	Oct. – Dec. 2017	2017 YTD
Bloomberg Barclays U.S. Aggregate	U.S. Broad Market Bonds	0.4	3.5
S&P 500	U.S. Large Cap	6.6	21.8
Russell 2000	U.S. Small Cap	3.3	14.7
MSCI EAFE*	Non-U.S. Developed Markets	4.2	25.0
MSCI EM**	Emerging Markets	7.4	37.3
Hypothetical 60/40 Portfolio[1]	Diversified Mix of Indexes	3.6	15.3

* Europe, Australasia, and Far East ** Emerging Markets
[1] 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM
An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

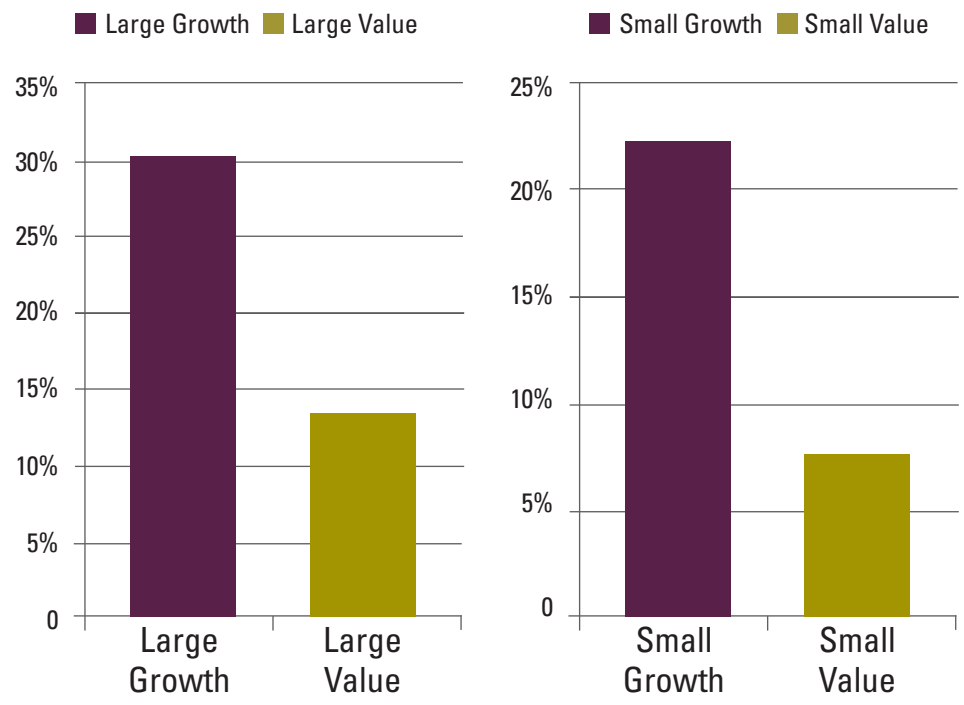
Tech sector leads the way as bull run continues

The bellwether large cap index, S&P 500, continued its march higher in the fourth quarter. Including dividends, the S&P had a positive return in each month of 2017 and finished the year at a robust +21.8 percent. The technology sector led the way, with the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google) — a phenomenon we wrote about earlier this year — up on average nearly 50 percent for the year (Morningstar). Strength was broad-based, though, as nine of the 11 S&P sectors posted returns of at least 10 percent. Only two sectors, telecommunication services and energy, posted negative returns, down a modest -1 percent each (Standard & Poor's).

Small company stocks, as measured by the Russell 2000, also advanced, finishing up nearly 15 percent for the year. Although small company stocks have provided higher returns than large company stocks in the long run, 2017 marked the third calendar year out of the last four in which small companies lagged the returns of large companies.

There was also a notable divergence in the returns of U.S. stocks by relative price, which is to say, between stocks classified as growth versus value. Growth stock indices, whose largest sector exposure is technology, soared due to the likes of the previously mentioned FAANG stocks.

2017 Returns of Large Growth Versus Value and Small Growth Versus Value



Source: Morningstar

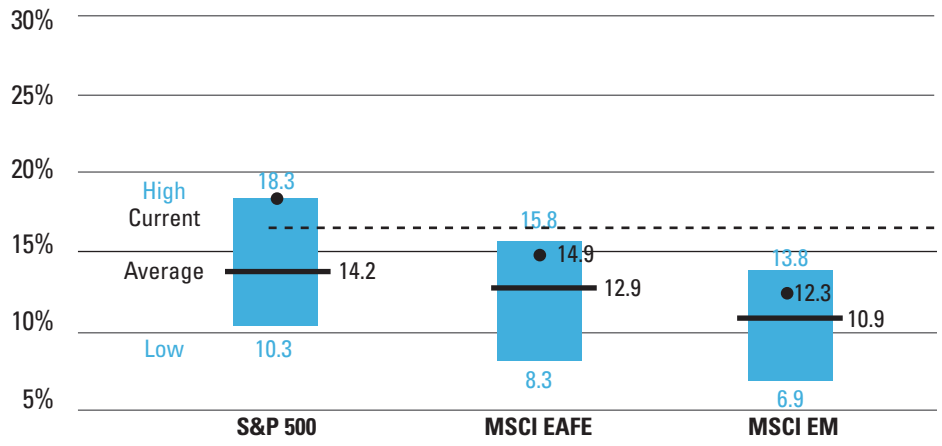
Just as small stocks have outperformed large on average and over time, value stocks have beaten growth (Morningstar). Investment strategies that are managed to take advantage of the long-term benefits of tilting portfolios to small and value have thus underperformed in the broad market. 2017 is a reminder of how any given year may deviate dramatically from the average.

Global stocks outperform U.S. stocks

Still another notable example of relative performance in 2017 is found in U.S. versus international stocks. In the January 2017 *Market and Economic Outlook* we contemplated how U.S. stocks had dominated international in recent years, with U.S. stocks outperforming in seven of the nine calendar years ending in 2016. At that time we encouraged investors not to get discouraged that international stocks "weren't working" and advocated patience with a globally-diversified portfolio.

In 2017, such patience was rewarded as both developed-country international stocks (MSCI EAFE Index, +25 percent) and emerging markets stocks (MSCI EM Index, +37 percent) outperformed U.S. stocks. The U.S. dollar fell more than -9 percent versus a basket of foreign currencies in 2017, which boosted returns in international investments for U.S. investors. It is also interesting to note that, despite the outsized gains in the past year, both international and emerging markets stock are still more attractive from a valuation standpoint (see chart below). We continue to be staunch advocates for a globally-diversified portfolio.

Current Next 12 Month Price/Earnings Ratio Versus 10-Year High, Low, and Average



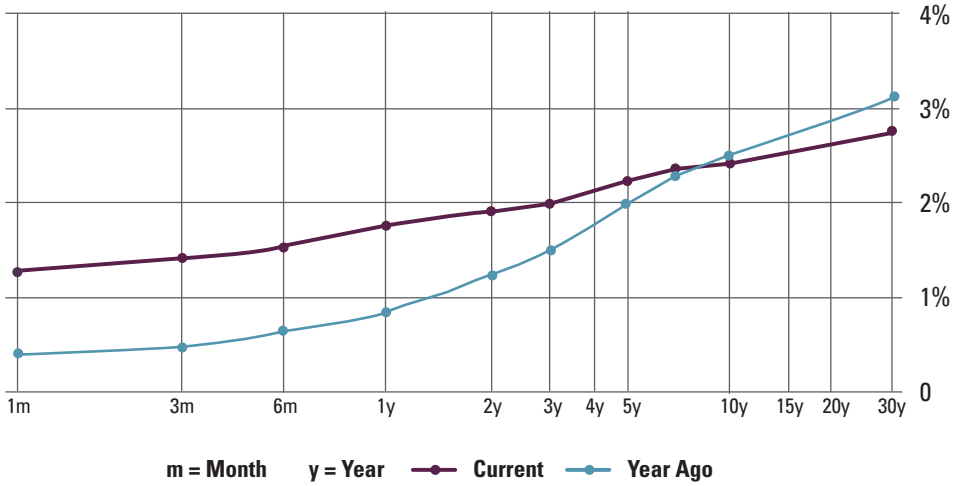
	S&P 500	MSCI EAFE	MSCI EM
High Date	11/17	5/15	12/07
Low Date	9/11	10/08	10/08

Source: FactSet as of 11/20/17. NTM P/E is market price per share divided by expected earnings per share over the next 12 months.

Shorter-term bond yields rise

By plotting the yields of U.S. Treasuries across maturities, you can see the shape of the yield curve (see chart above right). While this may seem a mundane exercise, market analysts will often examine the yield curve for potential insights about the current and future state of interest rates and the economy, typically focusing on the spread between the two-year and 10-year U.S. Treasuries. The yield curve has been flattening rather dramatically, i.e., the spread between shorter (two-year) and intermediate (10-year) has become increasingly smaller. Economists and market analysts traditionally view a flat yield curve as a negative signal for the economy.

Yield Curve, U.S. Treasuries



Source: MarketWatch

If we compare the current curve to its state one year ago, we see that the flattening was caused by the shorter-term yields rising, while longer, 10-year rates have stayed rather stable. The move on the short end of the curve has been dramatic, with the one-year Treasury yield spiking to its highest level since March 2008 (Bloomberg). This has resulted in some pain for short-term bond investors, as many shorter-term bond indices having a slightly negative return in fourth quarter 2017 and virtually flat returns for the year.

What is creating this somewhat unusual situation? The shorter maturities are responding mainly to Federal Reserve (Fed) rate policy. With the Fed finally moving off of a zero interest rate policy, and signaling further rate rises in 2018, higher yields for shorter-term bonds seem intuitive. As we stated, the intermediate part of the yield curve, which is viewed as responding more to growth and inflation expectations, has been much more stable. This can be viewed as positive, and mitigates concerns about a recession signal from the flat yield curve. BlackRock's Chief Investment Strategist, Richard Turnill, has directly stated

the yield curve is pointing to sustained global economic expansion rather than recession (*What the Flattening Yield Curve Means*, December 2017, BlackRock).

Municipal bonds may benefit from tax reform

Municipal bonds, meanwhile, provided healthy returns in 2017 (+5.5 percent according to the Bloomberg Municipal Total Return Index) and appear to have a strong fundamental backdrop for the coming year. The newly-passed tax law appears to be a positive for the supply and demand of tax-exempt municipal securities. Municipal issuers will lose the ability to engage in advance refunding (whereby governments take advantage of lower rates by issuing new bonds to pay off existing bonds), which has been a significant source of new municipal bond supply over the past 10 years. Simply put, the forecast of a lower supply of securities — in combination with increasing state and local tax revenues — bodes well for the demand (price) of municipal bonds.

What tax reform means for investors and the economy

President Donald Trump and the Republican party won a hard-fought political battle by passing the *Tax Cuts and Jobs Act*. The new law is expected to have a significant impact on the economy, taxpayers, and capital markets. Let's look briefly at just a few of the items that may affect investor outlook for 2018 and beyond.

Many believe the new tax laws will be constructive for business and the markets. As reported in previous issues of *Market and Economic Outlook*, both consumer confidence and business owner confidence have been increasing and the tax changes may further spark Americans' animal spirits. In its latest survey (November 30, 2017), the National Federation of Independent Business Index of Small Business Optimism, posted the second highest reading in the index's 44-year history. Small business owner optimism may lead to significant capital investments and plans to hire more people. There is also evidence that the prospect of lower taxes is stoking consumer spending. According to MasterCard SpendingPulse, which uses data from online and bricks-and-mortar shops, and includes all payment types, the 2017 holiday shopping season saw an increase in spending of nearly 5 percent, the largest year-over-year jump since 2011.

A reduction in the corporate tax rate, from 35 percent to 21 percent, is a major component of the new tax act. Many CEOs of major U.S. corporations commented favorably on the cut, including those of AT&T, Apple, and CVS, to name a few. Proponents believe the new, lower rates will drive investment and future growth, which will benefit shareholders and employees.

Some sectors may benefit more than others from the new tax law. Banks will directly benefit from the lower 21 percent tax rate and are expected to see an increase in business due to the parts of the law that will deter U.S. companies from having large amounts of off-shore transactions and cash holdings. For example (per a Bloomberg analysis of a hypothetical new corporate rate of 20 percent), Wells Fargo, Bank of America, and JPMorgan would see an annual profits increase of more than $1.5 billion (Bloomberg News, Sept. 29, 2017). Analysts believe builders, asset managers, and health care (especially drug manufacturers and medical supply companies) will also benefit greatly from the new tax law provisions.

Like many pieces of major fiscal reform, the ultimate success or failure is a story yet to be written. Detractors of the *Tax Cuts and Jobs Act* may state that the economy doesn't need fiscal stimulus, as we are nine years into an economic expansion, nearing full employment, and we have record stock market performance. In addition, The Joint Committee on Taxation, a nonpartisan group, states that the new bill will add $1 trillion to the public debt over 10 years. Others predict the debt will swell my $1.4 trillion or more. The Republican authors of the tax bill counter that the cuts will stimulate growth and enough revenue to pay for itself. Again, this has yet to be seen.

Bitcoin illustrates the difference between investing and speculating

Bitcoin is a digital currency whose origins can be traced to a 2008 white paper written by a still-unknown author using a pseudonym. Especially during the fourth quarter of 2017, Bitcoin became all the rage in the financial press and nearly ubiquitous cocktail party chat fodder. Bitcoin's price rise was astonishing to behold, with a 2017 year-to-day gain of more than 1,600 percent at its peak. We dare say the reason for this was not popular interest in cryptography or distributed networks, but rather good, old fashioned speculative fervor. Many market watchers equated bitcoin to famous market bubbles, such as Tulip Mania or the South Sea Bubble. A joke making the rounds on Twitter (author unknown) exemplifies the interest in the ultra-volatile digital currency:

A bitcoin-trading father asked his child what she wanted for her birthday. "I want one bitcoin," she responded.

"What?!?" exclaimed the father, checking his screen for bitcoin price quotes.

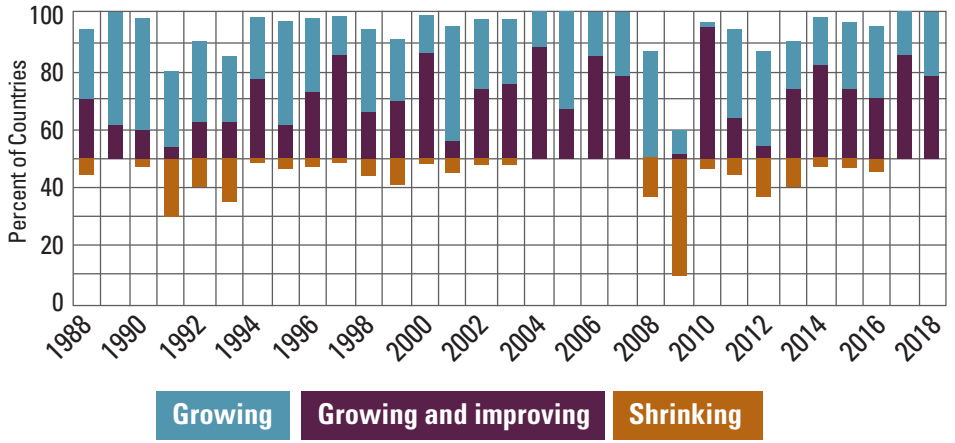
"$15,554 is a lot of money … I mean, $13,759 is a lot of money. And what do you need $16,211 for anyway?"

We think it's important to delineate between investing and speculating. Investing is about growing wealth over time while prudently managing risk. Speculating is more akin to gambling — buying an asset based on conjecture that it may skyrocket in price overnight, but with risk of devastating loss. Attempting to trade bitcoin by guessing at its short-term price movements should properly be considered as a speculation and not an investment. We do note, however, that blockchain, the technology upon which bitcoin and other cryptocurrencies are based, holds great promise and has many potential applications across various industries.

Global growth in synch

U.S. investors have certainly enjoyed a Goldilocks environment in recent times — high returns, low volatility, economic growth, and modest inflation. But we are not alone in experiencing robust economic growth and rising asset prices. For the first time in a decade, all 45 countries tracked by the Organization for Economic Cooperation and Development grew economically at the same time.

Percent of Countries Showing Economic Growth, 1988 – 2018



Source: Organization for Economic Cooperation and Development (OECD), Macquarie, as of October 2017. Shows OECD real GDP growth plus forecased percentage of countries with positive and increasing annual GDP growth rates.

Although economic growth does not always equate to rising stock prices, the markets in all of these major countries posted positive returns in 2017. Below we see those returns represented by country-specific exchange-traded funds (total returns in U.S. dollars).

Exchange-Traded Funds by Country: 2017 Total Returns (in U.S. Dollars)

Country	2017 YTD %	Country	2017 YTD %	Country	2017 YTD %
Poland	54.8	Thailand	31.5	Switzerland	23.4
Argentina	53.9	Taiwan	30.4	Norway	22.4
Austria	52.5	Nigeria	29.9	United States	22.3
South Korea	49.2	Ireland	29.8	Sweden	21.9
Chile	41.8	Peru	29.7	United Kingdom	21.6
Vietnam	38.8	France	29.1	Philippines	20.2
India	38.5	Italy	28.7	Australia	19.9
Turkey	37.6	German	27.4	Indonesia	19.2
Hong Kong	36.5	Spain	27.0	Canada	15.7
China	36.2	Egypt	25.8	Mexico	14.5
South Africa	36.0	Malaysia	24.3	Israel	12.8
Singapore	34.8	Japan	24.3	Columbia	11.9
Greece	34.8	New Zealand	24.1	Saudi Arabia	6.2
Netherlands	33.8	Belgium	23.7	United Arab Emirates	5.0
Portugal	31.6	Brazil	23.7	Russia	3.9

Source: Morningstar

Indicators moving in a positive direction

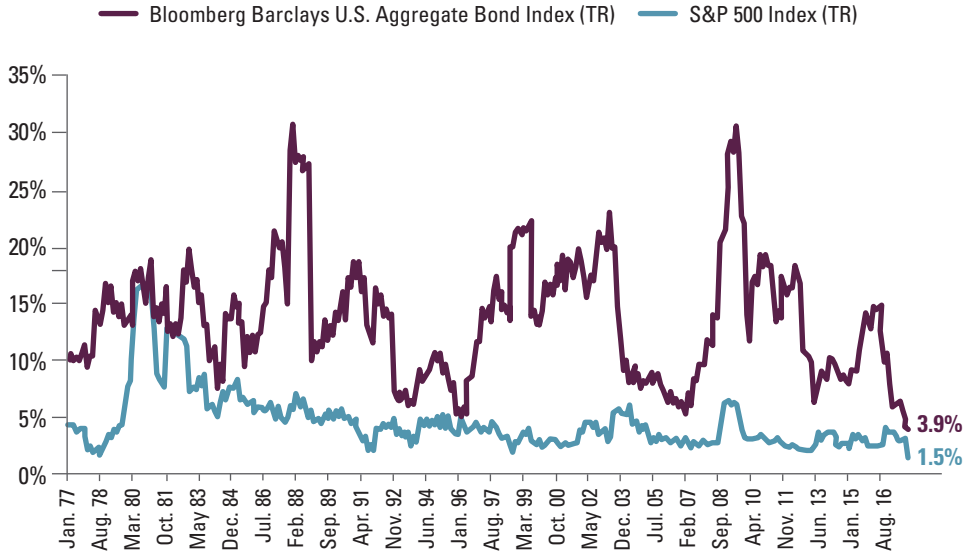
In the U.S. specifically, good economic news abounds. The economy has been in expansion mode for 102 consecutive months. In December, the Bureau of Labor Statistics reported the addition of 148,000 jobs — a record 87th consecutive month of jobs growth. Perhaps even more promising, there are signs that wage growth, long moribund, even in the midst of falling unemployment, might actually be perking up.

U.S. Unemployment and Wage Growth

Source: Bloomberg. Data through October 2017.

Many other economic indicators, such as housing starts and household net worth, continue to move in a positive direction, and inflation remains benign. The Leading Economic Indicator Index shows no signs of imminent recession (The Conference Board). Corporate profits are also strong. Analysts expect the S&P 500 to report a profit margin of 11 percent in 2018, the highest number in the last 10 years (Factset). We also have remarked fairly often about the unusual calm in asset prices, with both stock and bonds exhibiting what can be described as historically low volatility.

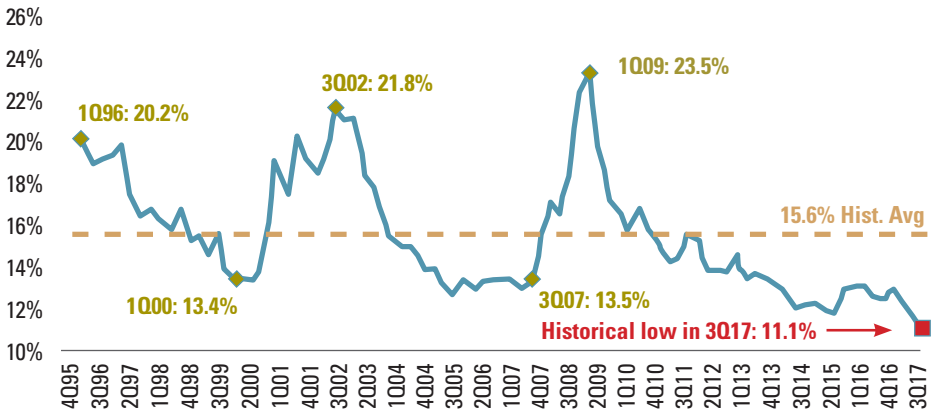
12-Month Volatility in Stocks and Bonds, 1977-2017



Source: Pension Partners

Given all the positivity, what are the risks to the economy and the market? Geopolitical risks at times appear to be proliferating. The markets could also be affected negatively by the Fed if rates policy becomes too restrictive or the process of unwinding their massive balance sheet causes dislocations in the markets. In addition, there are some signs of what can be described as euphoria among investors, with just two examples being: cash holdings of assets held at Schwab Corporation are at a record low (see chart on next page); and the American Association of Individual Investors' survey "bull ratio" is approaching 80 percent, the highest reading in 10 years.

Investor Cash Holdings



Source: Morgan Stanley

Here's to continued optimism and growth in 2018

2017 was a fruitful year in the capital markets. As we look forward to 2018, we are generally optimistic on capital markets and hopeful that the U.S. economy can continue to grow, even as we remain vigilant to risks. We wish you all a healthy and prosperous 2018.

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