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Market Update

Q4 2017 Review and Outlook

Global equity markets finished the year with solid gains; emerging markets remained strong and domestic markets got a late bump from tax reform. The broad bond market posted modestly positive returns as the Fed raised rates in December, its third hike of the year.

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The Markets at a Glance

Asset Class	Representative Benchmark	Q4 Return	2017 Return
U.S. Large Cap	S&P 500	6.6%	21.8%
U.S. Small Cap	Russell 2000®	3.3%	14.6%
International	MSCI EAFE	4.2%	25.0%
Commodities	Bloomberg Commodity	4.7%	1.7%
Municipal Bonds	BBgBarc. Municipal	0.8%	5.5%
Taxable Bonds	BBgBarc. Aggregate	0.4%	3.5%
Cash	Citi 3-mo T-Bills	0.3%	0.8%

Performance returns are as of 12/31/17

Q4 Recap

U.S. stocks continued their grind higher with most major indices ending the quarter near record highs. The S&P 500 returned another 6.6% in Q4 resulting in a 21.8% return for 2017. 2018 also started with a bang as the S&P 500 returned 4% in the first two weeks of trading with only one down trading day. The economic backdrop remains solid and new tax reform legislation provided an additional tailwind into year-end. Growth consistently outperformed its value counterpart in 2017 and large caps outperformed small caps.

Despite finishing the year ahead of domestic markets, foreign developed stocks took a backseat to U.S. markets for the first time all year in Q4. Emerging markets continued to dominate and ultimately posted a 37% annual return. In addition to firming fundamentals, a weaker U.S. Dollar and strengthening commodity prices helped boost EM markets.

The broad U.S. bond market returned 0.4% in Q4. The FOMC raised their target fed funds rate in December, marking the third hike of the year. Fed tightening and subdued inflation led to a flatter yield curve as the short end rose. Strong demand and improving growth expectations also tightened investment grade and high yield spreads. Municipal bonds again outperformed their taxable peers as issuances were pulled forward to avoid new tax legislation.

Implications of Tax Reform on Financial Markets

Tax Reform Signed, Sealed & Delivered

The 4Q17 airwaves were dominated by Washington DC banter about tax reform, which culminated in the passing of the Tax Cut and Jobs Act in late-December. The combined tax reform bill includes lower tax rates for individuals and businesses in addition to revised deductions. However there was plenty of market speculation ahead of President Trump signing it into law as investors assessed winners and losers. We provide an overview of corporate and financial market implications below.

For a comprehensive outline of changes to the individual tax code, please review Baird's Highlights of the Bill written by Tim Steffen, Director of Advanced Planning. Also please reach out to your Financial Advisor if you would like to discuss your personal portfolio.

Key Changes to Corporate Tax Code

The largest benefit for US corporations is a tax cut from 35% to 21%. Multinationals must also consider a repatriation tax cut, which lowers the tax rate on overseas cash returned to the US to 15.5% from 35% previously. While the bill includes other changes, we will focus on these two when assessing the implications on corporations and financial markets. The tax overhaul will have varying impacts on companies (and each should be assessed individually) but we outline some general implications below.

Economic Implications

The one-time economic impact should be modest given full employment and the late phase of the economic cycle. Most economists are estimating a 0.25% boost to 2018 GDP (consensus at 2.6%).

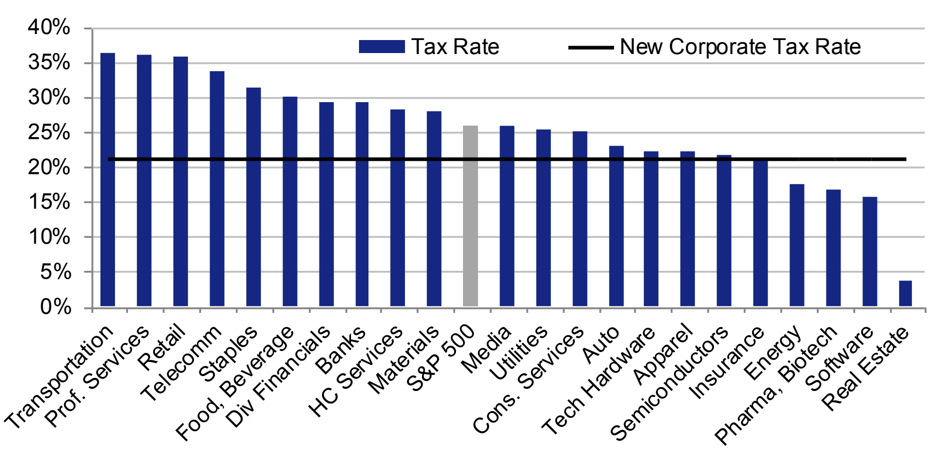
It remains to be seen how companies will deploy repatriated cash. A portion will likely be invested back into businesses, which would benefit the economy. Though some speculate more M&A, share buybacks and dividends, which was the case for the 2004 tax holiday.

Equity Market Implications

Equity markets viewed the news as decidedly positive (and reacted accordingly) given the one-time earnings boost. Economists estimate a mid-to-high single digit bump in S&P 500 EPS growth in 2018. This results in low double digit growth estimates given mid-single digit organic growth (vs. mid-single digit EPS growth in 2017). This has positive implications for market valuations as well.

Not surprisingly, tax reform favors industries and companies that derive a large portion of earnings domestically. This benefits small– and mid-cap companies more than larger peers given outsized domestic exposure. Sectors poised to benefit most include Telecommunications, Consumer Discretionary, Consumer Staples, and Financials. Technology, Health Care, Materials and Energy should benefit less given the dominance by large multi-national corporations. Not surprisingly, December performance correlated with the expected benefit.

Figure 1: 2016 Tax Rate by Industry



Source: Strategas Research Partners

Fixed Income Market Implications

The recent changes to tax legislation also affected fixed income markets. Tax reform could be beneficial to bondholders going forward. Increased cash on balance sheets coupled with more fluid access to capital held abroad will likely result in less new issues, reducing supply and creating a scarcity premium. While the high yield market may be a modest loser given the limits on interest deductibility, investors may still be advantaged as these limits could encourage corporations to delever, improving their overall credit risk to bondholders.

Tax-exempt bondholders also seem to be in a better position. The elimination of pre-refunded bonds will reduce market supply and could balance lower demand for municipal bonds from banks, insurance firms, etc. given their new lower tax rates. Lastly, state and local tax deductions are now capped at $10,000 likely increasing the demand for municipals from investors in high tax states seeking shelter. This could potentially decrease the credit quality of issuers in high tax states, as it may hamper the ability to raise taxes to address financial constraints or infrastructure needs/healthcare aid.

U.S. Equity

U.S. Equity Market Benchmarks

Equities	Representative Benchmark	Q4 Return	2017 Return
Large Cap	S&P 500	6.6%	21.8%
Mid Cap	Russell Midcap®	6.1%	18.5%
Small Cap	Russell 2000®	3.3%	14.6%
Value	Russell 3000 Value	5.1%	13.2%
Growth	Russell 3000 Growth	7.6%	29.6%

Performance returns as of 12/31/2017

Equities Continue their Record Run

U. S. Equity markets surged higher into year-end and closed within a stone's throw of recent record highs. The S&P 500 notched a 6.6% gain in 4Q17, capping off an impressive year of performance in which the index returned 21.8%. 2018 started on a similarly strong note with the S&P returning over 4% in the first two weeks of trading, including only one down day in the first nine.

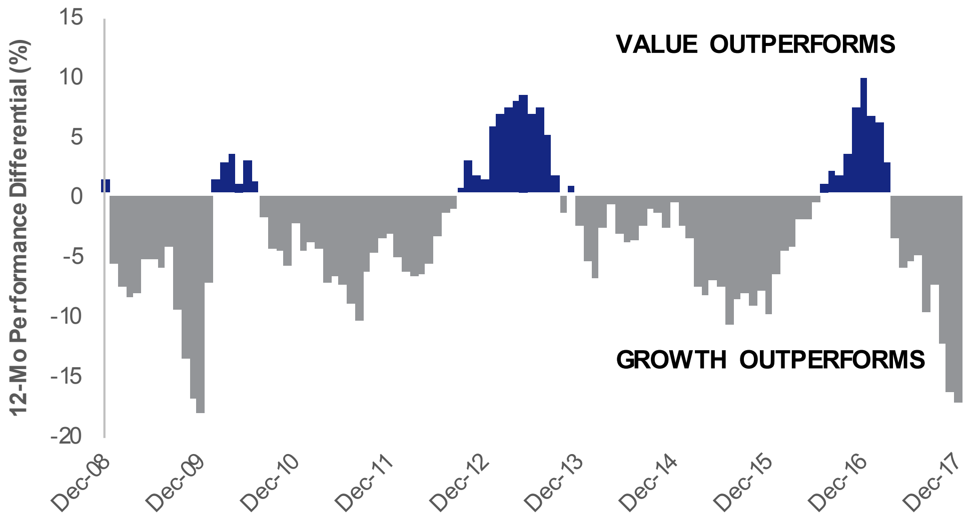
Perhaps more interesting though is the continued outperformance of growth over value and large caps over small caps. Large Growth outperformed its Value counterpart by 16% in 2017 (30% vs. 14%), while large caps outperformed small caps by 7% over the same period (22% vs. 15%). This trend held true in 4Q17 across the entire market cap spectrum. As seen in Figure 2, the magnitude of growth outperformance is approaching peak levels last seen in 2009 though the duration is much shorter than previous cycles. Time will tell as to whether this is a tipping point for value to outperform or a head fake for hopeful active investors.

Sector Performance

All sectors ended the quarter in positive territory with Consumer Discretionary, Technology, and Financials topping the rankings. Conversely, Utilities and Health Care were the weakest sectors as they are expected to benefit less from the new tax legislation. For the year, Technology posted a staggering 39% return as its dominance continued. Only Telecomm and Energy ended the year in negative territory, albeit very modestly. Utilities and Consumer Staples also lagged the broad market for the year as the yield trade of late lost steam.

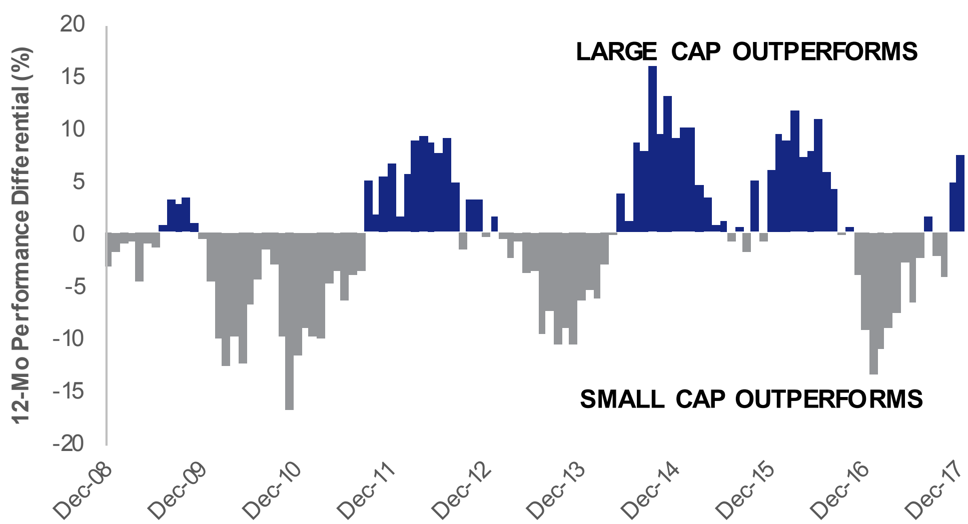
Interestingly, there was some sector dispersion late in the year as investors speculated the winners and losers of tax reform. For instance, Telecommunications was the top performer in December, while Utilities and Health Care posted losses. Technology also ended the month flat as that sector operates more internationally as a whole; though it could be a main benefactor of repatriation tax breaks.

Figure 2: Growth Dominates in 2017



Source: Morningstar Direct

Figure 3: Large Cap Leadership



Source: Morningstar Direct

International Equity

International Market Benchmarks

Equities	Representative Benchmark	Q4 Return	2017 Return
Developed	MSCI EAFE	4.2%	25.0%
Europe	MSCI Europe	2.3%	26.2%
Japan	MSCI Japan	8.5%	24.4%
Asia	MSCI Pacific ex-Japan	7.0%	26.0%
Emerging	MSCI Emerging Mkts	7.4%	37.3%

Performance returns as of 12/31/2017

Continued International Strength

Despite finishing the year on top of domestic markets, foreign developed stocks as measured by the MSCI EAFE took a backseat to US markets for the first time all year in Q4, returning 4.2% vs. the S&P 500's 6.6%. Positive economic data was the primary driver for quarterly overseas gains.

Eight of the ten sectors posted positive returns. Most notably, economically-sensitive and cyclical sectors led markets higher. The only laggards were found in defensive Utilities and Healthcare which posted modest losses of 1.3% and 0.6%, respectively. Regionally, Europe underperformed despite improving economic data and news that the ECB's quantitative easing program would be extended to September 2018. Japanese equities earned an impressive 8.5% for the quarter following Prime Minister Shinzo Abe's victory in a snap election which quelled concerns over the continuation of the country's current monetary and fiscal policies. Foreign inflows following the election, better-than-expected December economic data and strong earnings all contributed.

Emerging Markets Lead

Emerging markets advanced 37% over the year, surpassing developed ex-US and US equities which rose 25% and 22%, respectively. The primary driver was strong fundamentals; inflation remains low, profitability and growth remain solid, and currencies continue to recover against the US Dollar.

In Q4, all ten sectors in the MSCI Emerging Markets Index were positive. Most notably, Healthcare returned 16.6% due to outsized returns from a small number of Southeast Asian biotech names.

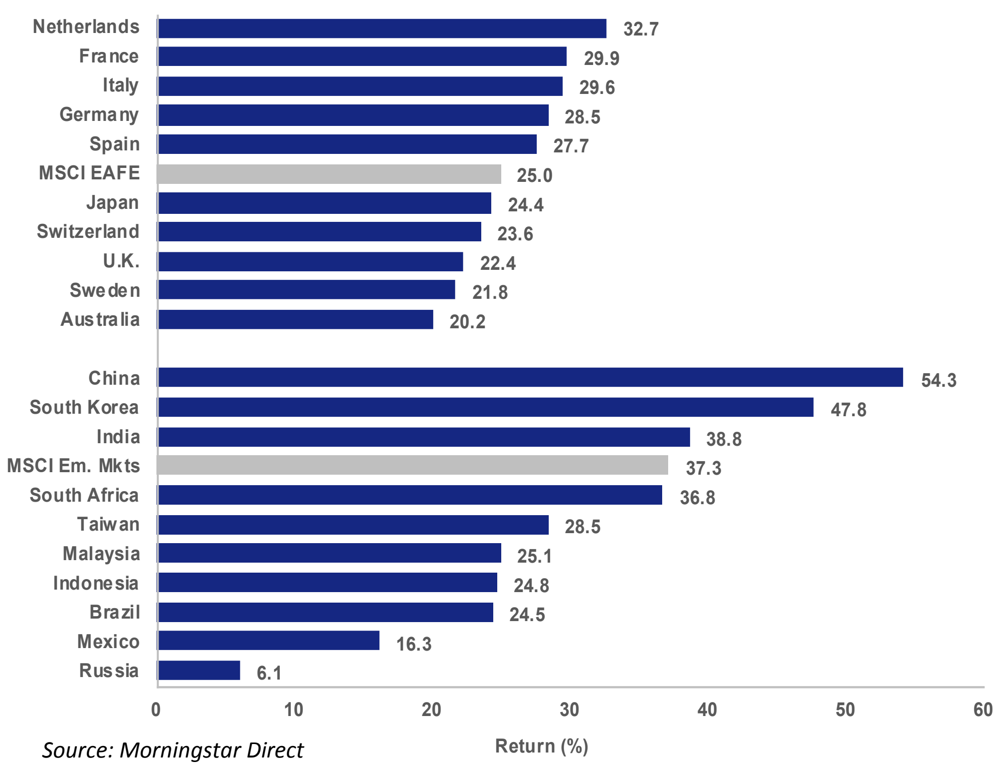
From a country perspective, all posted positive quarterly returns except Mexico (-8%) and Brazil (-1.9%) which was mostly due to currency weakness and secondarily, geopolitical instability. South Africa surged to finish the quarter up 21.5% following Cyril Ramaphosa's appointment as head of the ruling African National Congress (ANC). Ramaphosa, a billionaire investor is pro-business and is a favorite to overtake current president Jacob Zuma, currently under fire for corruption charges, in the 2019 general elections.

Also outperforming were China (7.6%) on good earnings and growth numbers, South Korea (11.6%) on reduced diplomatic tensions with China, and India (11.8%) on a vote to reform state-controlled banks.

Annual gains were extremely concentrated from a sector perspective, with financials and tech accounting for approximately 60% of 2017 returns. Stylistically, the year was dominated by momentum and growth based stocks, however Q4 saw the beginnings of a rotation to value equities.

The dollar strengthened in Q4 on anticipation of the tax reform vote, but the magnitude of impact on global asset flows remains to be seen.

Figure 3: 2017 Country Performance



Source: Morningstar Direct

Fixed Income

U.S. Fixed Income Benchmarks

Equities	Representative Benchmark	Q4 Return	2017 Return
Taxable	BBgBarc. Aggregate	0.4%	3.5%
Treasury	BBgBarc. Treasury	0.1%	2.3%
Corporate	BBgBarc. Corporate	1.2%	6.4%
High Yield	BofAML HY Master II	0.4%	7.5%
Municipal	BBgBarc. Municipal	0.8%	5.5%
Internat'l	BBgBarc. Global Agg.	1.1%	7.4%

Performance returns as of 12/31/2017

More Of The Same With Fixed Income

The US economy built momentum through 2017; key themes included a strong economic backdrop, healthy jobs market, Fed rate hikes and tightening credit spreads. The FOMC raised their target fed funds rate in December, marking the third hike of the year. The Fed's decision to tighten monetary policy coupled with subdued inflation led to a flatter yield curve as short rates rose more than longer rates (Figure 4). For the quarter, two-year Treasury rates rose 40 bps while ten year yields were only 6bps higher. Outside of rate movements, strong demand for bonds coupled with improving economic growth expectations pushed spreads tighter throughout the investment grade and high yield universe. Within corporate credit, lower quality issuers performed best, with BBB returning 1.2% vs. 0.9% for AA-rated issues.

Encouraging Growth Prospects Abroad

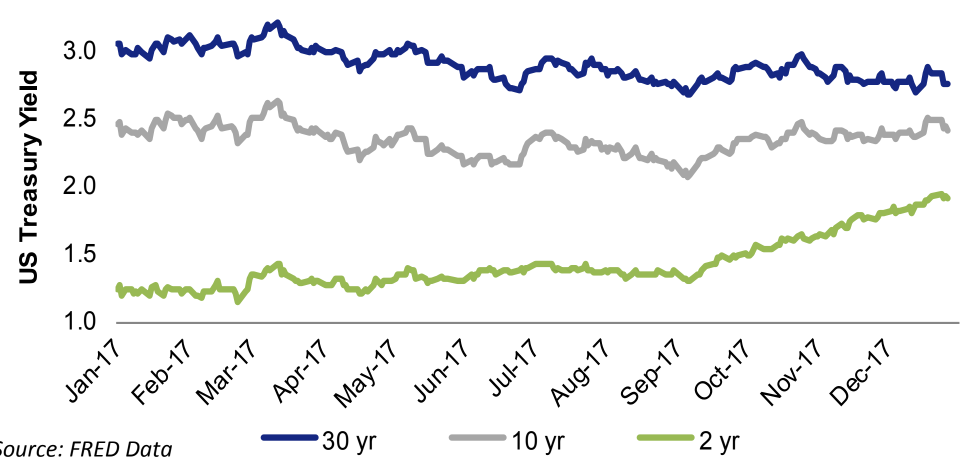
On the international front, global fixed income investors benefitted from continued quantitative easing, a supportive economic backdrop and a weaker US dollar. As global growth picked up in the quarter, European debt again provided investors with robust returns yielding 2.2%. In Asia, Japan started to show signs of budding inflation. Bank of Japan Governor Kuroda and Prime Minister Abe received well-deserved credit for the success of their fiscal reform program, Abenomics. Evidence of its success and popularity culminated in a snap-election victory in 4Q17. Against the backdrop of continued above-trend growth and rising inflation , some investors, however, are speculating the BOJ could slow its balance sheet expansion and tweak its yield curve control policy resulting in a steeper curve.

Emerging market bonds had consistent demand in Q4 with both external and local debt posting positive returns. Local debt performance was driven primarily by appreciation of emerging market currencies versus the US dollar along with the upward trend in commodity prices.

Securitized Debt Posts Stellar Quarter

Securitized debt delivered strong quarterly returns as well. Non-agency mortgage-backed securities (MBS) was one of the best performing sectors in 2017. The sector benefited from faster prepayment rates as more borrowers became eligible to refinance. Legacy non-agency mortgaged debt is one of the more attractive sectors given improving fundamentals as investors delever and strengthen balance sheet.

Figure 4: Yield Curve Flattening



Source: FRED Data

Agency MBS ended the quarter up slightly, outperforming comparable duration Treasuries. The sector recovered as the gradual reduction in the Fed's balance sheet was digested by the market and investors sought the added benefits of additional yield and increased liquidity.

Much like other non-government sectors, asset-backed securities also posted positive returns relative basis in Q4. The best performing sector was student loans, which saw spreads tighten as the comfort level of market participants' increased regarding the ratings downgrades that took place in early 2017.

Municipals Enjoyed Positive Returns

Municipal bonds outperformed their taxable peers advancing 0.8% this past quarter. In Q4, investors were impacted by new tax reform legislation signed into law. Municipal bond prices experienced some downward pressure given record issuance and supply surging to almost $147B for the quarter. Issuers rushed to compensate for the possible elimination of some types of tax-exempt bonds as a part of the tax overhaul. Leaders in Q4 included taxable and high yield munis delivering 1.5% and 1.8% respectively.