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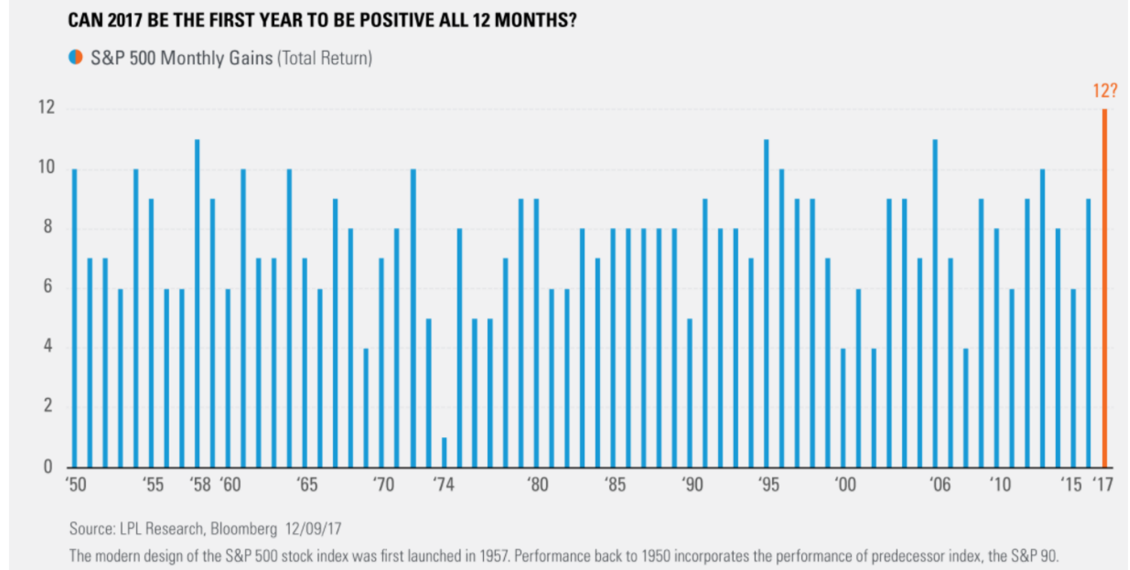
Investment Commentary

4th Quarter 2017

Below you will find our investment commentary for the most recent quarter. We hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call our office to schedule a meeting or conference call.

Economic Review & Outlook

As we begin 2018 it is difficult to remember a time when the global economy was in such a synchronized period of expansion. The U.S. housing market remains buoyant, consumer confidence is high, unemployment is low, interest rates are stable, the stock market is trading at a record level, and GDP is expected to top 2.5% in both 2017 and 2018. As if this wasn't enough, the U.S. just enacted one of the largest tax cuts in history to spur economic growth further. The reaction in the financial markets has been more than encouraging. The chart below illustrates what an unprecedented year it was for the S&P 500 Index. This index tracks 500 of the largest publicly traded companies in the U.S. For the first time in history the S&P 500 did not deliver a negative monthly return over a calendar year. Although we are quick to point out the performance of the stock market does not necessarily represent the strength of the economy, it is compelling evidence that suggests many of the fears expressed by countless media outlets over the economic policies of the Trump administration have thus far been unfounded.



Driving a car while looking in the rearview mirror is dangerous, so investors should not become complacent after a stellar 2017. While the tax cuts do provide some level of confidence the recovery will continue, David Rosenberg, chief economist at Gluskin Sheff, sent out a note to clients warning of the eerie familiarity the current environment has to past periods such as 1988, 1999, and 2006. Each of these years marked the end of a long economic expansion and ushered in a period of economic uncertainty. He highlighted ten late-cycle signposts:

- Expansion turning nine years old in June
- Cycle-high consumer confidence
- Excessive P/E multiples
- Peak autos/housing
- Full Employment
- Fed tightening
- Very tight credit spreads
- Decade-low savings rate
- Flattening yield curve
- Mergers & Acquisitions boom

Further, we have a new Federal Reserve Chairman, coinciding with four of seven Governor seats on the Federal Open Market Committee (FOMC) in transition. We all thought 2017 was going to be a volatile year for the economy and it turned out to be anything but the case. Only time will tell if the same level of uncertainty surrounding 2018 turns out to be just as benign, or if volatility reemerges in both the economy and financial markets.

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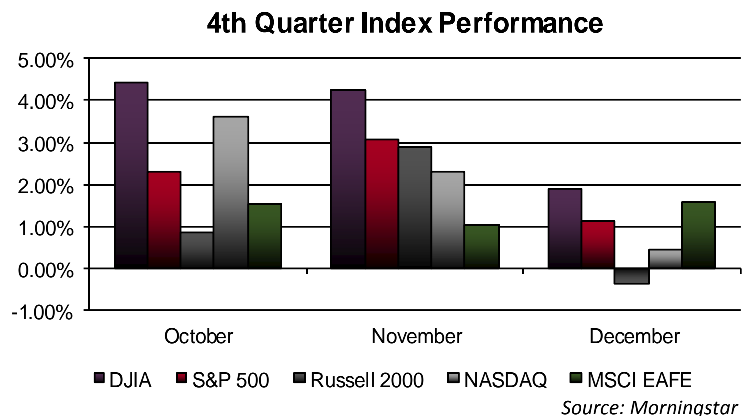
Bond Market Review & Outlook

The much-anticipated demise of the bond market continues to remain in hibernation. As has become an annual custom, we once again want to point out the fearmongering and irresponsible recommendations by so many in the financial media to steer clear of bonds was once again proven wrong. Although the stock market may have posted exceptional gains, for those looking to take substantially less risk, bonds performed superbly. The benchmark Barclays U.S. Aggregate Bond Index returned 3.5% for the year, while the Bank of America High Yield Index posted a total return of 7.5%. This is a far cry from the losses so many in the financial media have been predicting. Unfortunately, the average investor remains confused as the negative rhetoric surrounding the bond market continues. This is due almost exclusively to the perception that the Federal Reserve will raise interest rates between two and four times next year. If this does happen, most bonds will undoubtedly have a tough time delivering much in the way of total return. However, higher interest rates will also become problematic at some point for stocks given their current lofty valuations. Perhaps the best scenario for both stocks and bonds would be a steady rise in interest rates throughout the year, resulting in perhaps six to twelve months of flat to negative returns. This would potentially set up both assets for gains in 2019 and beyond. Regardless of how 2018 unfolds, bonds remain the best asset class an investor can use to reduce the volatility in their investment portfolio. We are making no changes to the allocations in our accounts and still maintain a well-diversified balance between core, high yield, and foreign bonds in all our managed accounts.

Stock Market Review & Outlook

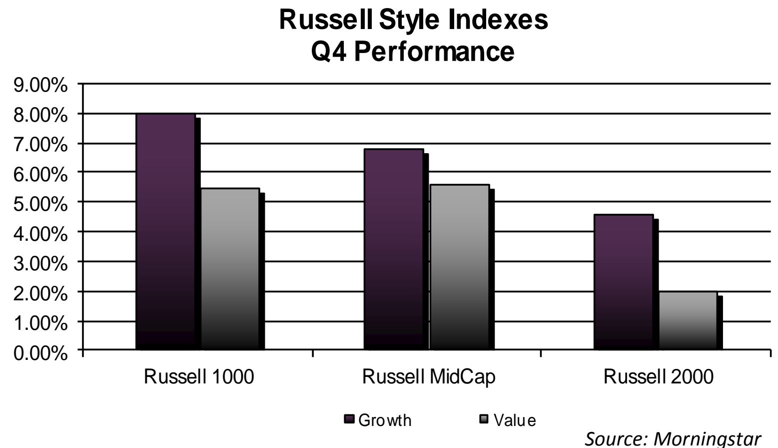
The S&P 500 has now delivered a positive return in 20 of the last 21 quarters. We started tracking this more than a year ago and it seems the streak simply will not end. Obviously, all streaks are eventually broken, but in the meantime, it is truly amazing to reflect on just how few pullbacks the current bull market has had in this time period.



Source: Morningstar

For the quarter, the Dow Jones Industrial Average (DJIA) and S&P 500 returned11.0% and 6.7%, respectively. The small cap Russell 2000 delivered a 3.3% return. The NASDAQ Composite had a total return of 6.3%. Finally, international stocks continued to perform well, returning 4.2% as measured by the MSCI EAFE. One segment of the market that outperformed all the aforementioned indexes last year was emerging market equities, delivering a total return of over 34% as measured by the MSCI Emerging Market (EM) Index. We've never talked much about this asset class in the past, but that is going to change. In the first quarter of 2018 we will be swapping out of the current international index funds in all our accounts and replacing them with the iShares MSCI Total International Index fund. This fund has approximately 30% of its portfolio allocated to emerging market equities. The international index funds we have been using do not have an allocation to emerging markets. This was an intentional decision we had made to avoid this asset class and it worked out very well for our clients. Over the past five years the more traditional MSCI EAFE index outperformed the MSCI EM index by more than 33%. This has resulted in emerging markets now being one of the cheapest asset classes throughout the world. In an environment plagued with expensive assets in every corner of the financial markets, emerging markets may be one of the last areas left to invest with a relative margin of safety. Further, to truly take advantage of this perceived value discrepancy, we are increasing our weighting in international stocks across all of our managed model portfolios. Thus, you can expect to see purchases into international funds in your accounts throughout the first half of 2018 as we primarily use new deposits to increase our weighting in this asset class.

Growth stocks closed out the year on a high note, once again outperforming value stocks by a not insignificant margin. When you compare the two over all of 2017, growth trounced value by more than 10% in all three market cap segments (large, mid, and small). We have mentioned this time and time again via our e-mail updates, webcasts, and quarterly letters how the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks continue to dominate the performance of the stock market. As 2017 ends, this outperformance shows no sign of slowing down. Although it is difficult to argue these stocks aren't extremely expensive using traditional valuation metrics, it cannot be denied that all of them are dominating their respective industries. In an environment with low interest rates and a lack of attractive investment opportunities, it seems likely these stocks will continue to lead this bull market higher until it ends. These stocks are all represented as top holdings within the S&P 500 index. This is an investment we gain access to via a mutual fund or ETF as a core holding in our managed accounts. Further, many of these stocks are also held within our proprietary stock portfolio, which suggests the performance of these stocks will have a major influence on how your accounts perform in 2018.



While we remain optimistic stocks can march further into record territory in 2018, a bit of caution is obviously warranted given the strong performance over the past couple of years. The S&P 500 index has gone more than 540 days without suffering even a 5% correction, the second longest streak in history. We often point out that bull markets rarely end due purely to old age. Typically, some type of unexpected shock to the economy or financial markets causes sentiment to shift, resulting in a sharp pullback that can eventually turn into a bear market. At some point this will occur, and investors will have to stomach losses, but trying to predict exactly when this will happen is dangerous to your financial future. We are aware of many investors who tried to do exactly this over the past 12 to 24 months and have been left out in the cold as stocks put together one of their best runs in decades. If you are one of the unfortunate ones in this camp, you have a choice of getting back on board with stocks at an all time high, or trying to play the waiting game even longer. For those of you who have made this mistake before, you recognize it is in many ways worse to be sitting on the sidelines earning next to nothing while everyone else is making money. Instead, taking a long-term approach and participating in the ups and downs of the market is how wealth is typically created. Ignoring the daily, weekly, monthly, even yearly noise that causes investors to make emotional decisions is the best advice we can give to long term investors. When the markets finally peak and you see your first monthly or quarterly decline in value, try to remember just how far your accounts have come over the past couple of years. What is really important is what your accounts will be worth a decade (or more) from now, not next month.

Sincerely yours,

McGill Advisors

Wealth Management Team
McGill Advisors