January 2018

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Animal Spirits

MARKET SUMMARY

Equities

S&P 500	2,674
Price / Earnings	22.4x
Dividend Yield	1.8%

US Treasury

2 Year Yield	1.9%
10 Year Yield	2.4%
30 Year Yield	2.7%

US Corporate Spreads

Investment Grade	0.9%
High Yield	4.0%

Volatility

CBOE Market Volatility	11.0

US Economic Figures

GDP Growth 3Q17	3.2%
Unemployment	4.1%
Inflation	1.8%
Fed Funds Rate	1.50%
3 Month LIBOR	1.69%

Commodities

Oil (Brent)	$69.87
Natural Gas	$2.95
Copper ($/lb.)	$3.22
Gold ($/oz.)	$1,303

Foreign Exchange

Euro	$/€	1.20
Japanese Yen	¥/$	113
Chinese Yuan	元/$	6.42

Market summary data as of:
December 31, 2017

English is a wonderful language. The British empire established it globally, and today it's *lingua franca* worldwide for business, technology, and science. It's also rather fun, with idioms that convey meaning while providing a bit of entertainment.

"Animal spirits" is a great example. From its latin origin, *animus*, alternatively meaning soul and courage, animal spirits has for centuries been used to describe an attitude that inspires optimistic action. Georgian and Victorian writers like Austen and Disraeli used the term to describe an individual with an ebullient and impulsive personality. More recently, economists have conscripted animal spirits to mean optimism that spurs capital investment. John Maynard Keynes described it in his General Theory as essential to capitalism. "If animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die."

There's been plenty of animal spirits at work in the economy and capital markets. With strong gains in the fourth quarter, stocks provided returns in 2017 at twice the rate of its long-term average. US stocks (S&P 500) returned 21.8%. International stocks (MSCI All Country World) returned 18.2% in local currency, with dollar weakness adding extra return for US investors. Bonds (Bloomberg Barclays US Aggregate) returned 3.5%, benefiting from a slight drop in long-term interest rates. Tightening corporate spreads afforded credit-oriented bond investors returns above the benchmark index.

Tacked on to gains achieved since the market bottom in 2009, the current bull market is of historic magnitude and duration. The current leg of the rally has been particularly relentless, now counting 14 consecutive months of gains -- the longest uninterrupted streak since 1928. It raises a few questions voiced by many of our clients. How much longer can this market go at the pace it's been running? Are there many innings left in the bull market, or are we in the 9th?

The quick (and rather unhelpful) answer is that we don't know. No one does. But as analysts and prudential stewards of your capital, we look at several measures that paint a picture of where we stand in the cycle -- what's the risk-adjusted opportunity presented by the capital markets and the commensurate stance appropriate for each of your portfolios.

Clients and readers of our letters won't be surprised that valuation is central to this analysis. With stocks trading 36% higher than historically normal valuations and with bond yields providing near-record-low compensation versus inflation expectations (exhibits 1 and 2), our medium-term outlook for stocks and bonds is for lower-than-historical returns. Valuation in capital markets mean-reverts, and we'll experience lower productivity from capital in the process.

Exhibit 1: S&P 500 Price / Earnings Ratio

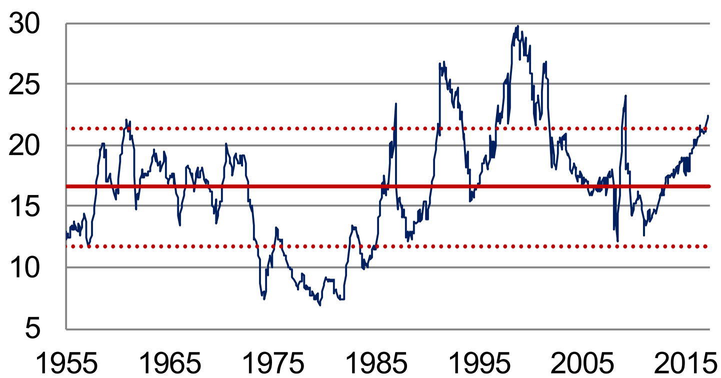
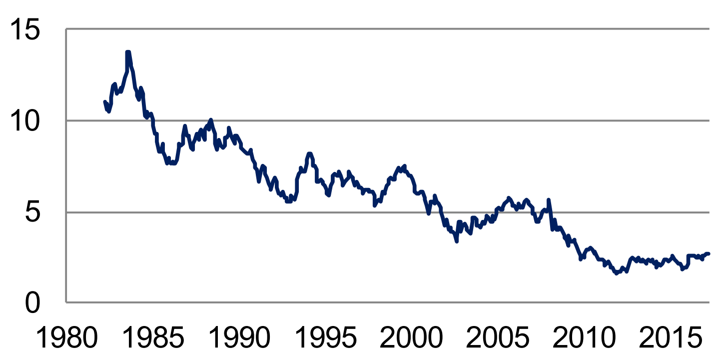
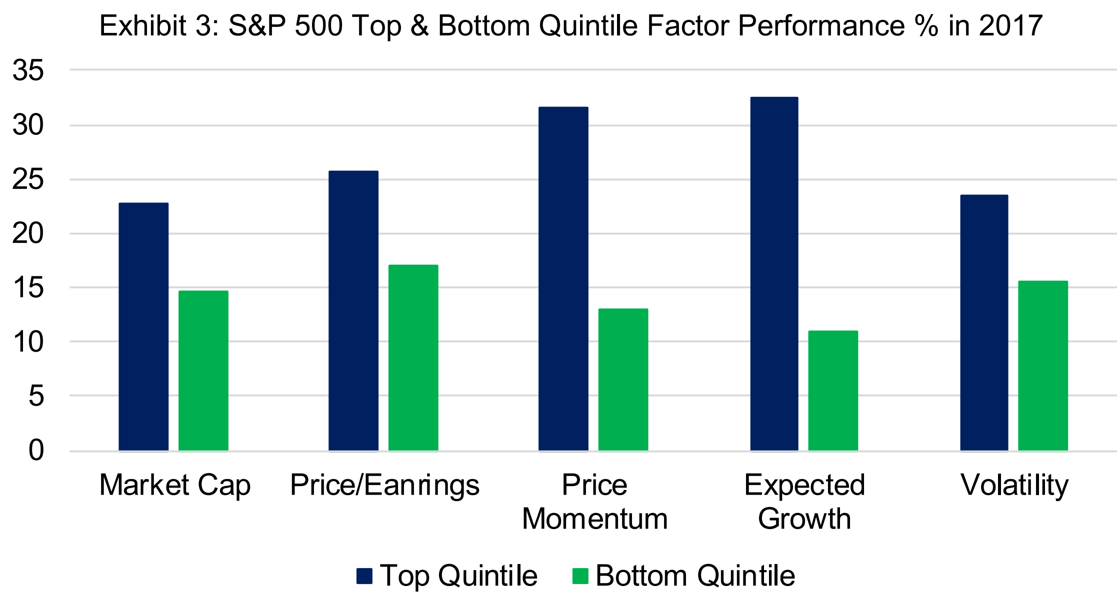


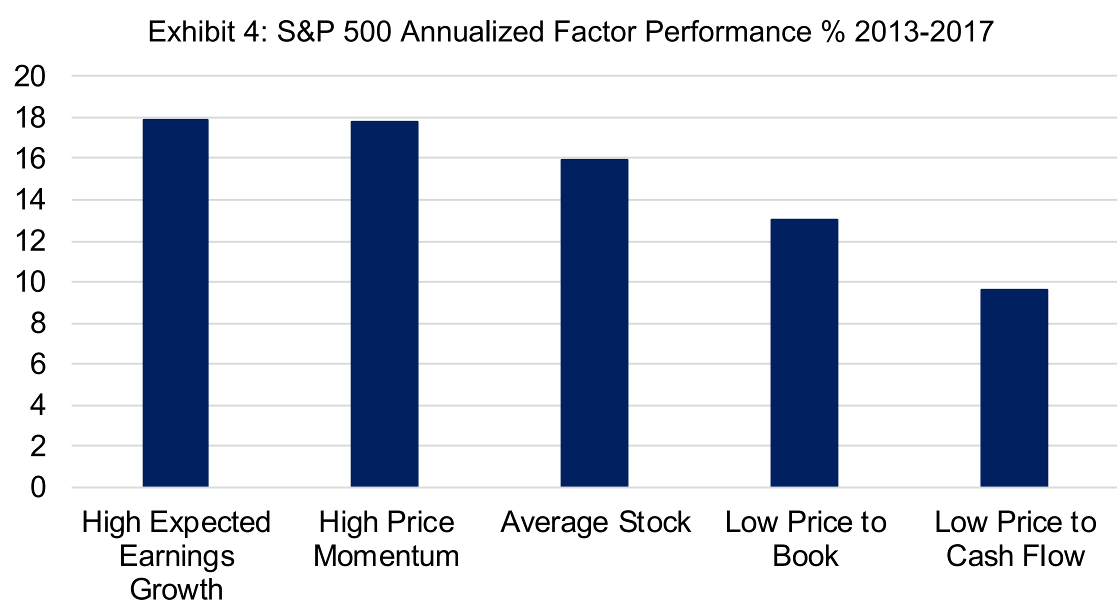
Exhibit 2: Bloomberg Barclays US Aggregate Yield %



Investor sentiment, meanwhile, is at a level similar to the technology stock market bubble eighteen years ago. Household asset allocation toward stocks (held directly, in funds, and in 401k accounts versus total financial assets) has reached levels last seen in the late 1990s. Cash levels, according to the American Association of Individual Investors, has reached a record low. Bond investors are likewise sanguine with collateralized loan issuance and covenant-lite loan new issuance reaching volumes in 2017 double that of prior annual records. Mr. & Mrs. Market certainly have animal spirits.

Trends within markets also bear the hallmark of enthusiasm. Stocks with speculative characteristics -- high valuation, price momentum, expected growth, and volatility risk vastly outperformed those that are lower priced, less dependent on aggressive earnings expectations, and less volatile (exhibit 3). 2017's market leadership by speculative stocks is a trend continued over the last several years (exhibit 4), and its accelerating relative performance marks a dynamic historically found in late stage bull markets.





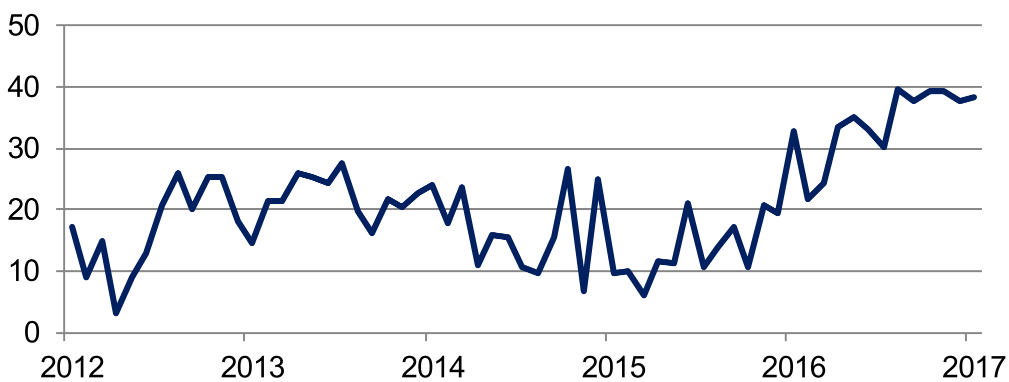
With valuation and sentiment elevated and with speculative investments outperforming safer ones, it's clear to us that there's materially higher-than-normal risk embedded in stock and bond markets and their indices. The long-term reward per unit of risk proposition is substantially lower compared with the historical average.

Yet, the trouble with analysis that combines valuation, sentiment, and market history is timing; it doesn't tell you when reversion to mean happens. To quote Keynes again, "the market can stay irrational longer than you can stay solvent." Indeed, we believe the increased popularity of index investing through traditional and exchange traded funds could extend the life of the most risk-seeking phase of the market cycle. Most passive investment products are based on market-capitalization-weighted indices, and they promote and self-reinforce increased exposure to what's recently performed best, irrespective of fundamentals and valuation. The bull market appears mature, but it can, in baseball terms, possibly go extra innings.

In our view, a key reason why markets can continue to perform well is the improving economy. Growth worldwide improved in 2017 (exhibit 5), and survey-based leading indicators suggest low near-term risk of recession. Willingness among businesses for capital expenditures, notably absent for many years, has risen (exhibit 6). Less regulatory burden and the recently passed US tax legislation are clearly positive for business, particularly those that are capital intensive. Government policy that's more supportive has released animal spirits among businesses that should help the economy.

Exhibit 5: Consensus 2018 GDP Growth % Estimate for Major Economies

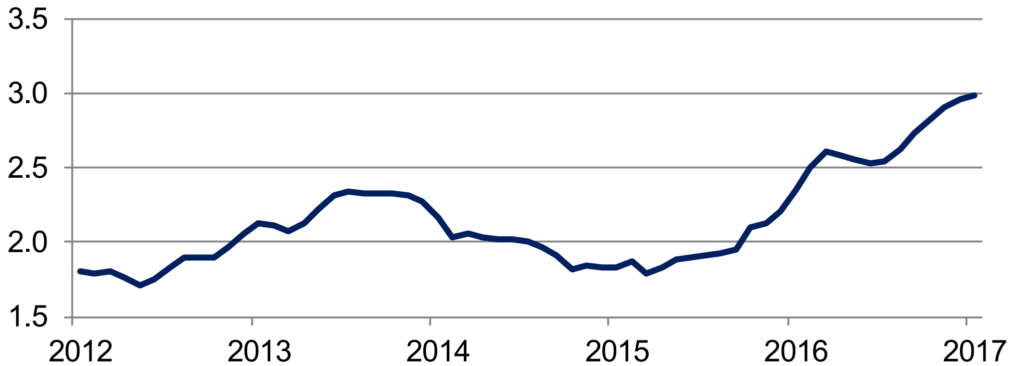
Exhibit 6: Philadelphia Fed Capital Expenditures 6 Month Forecast “Up” %



Our market and economic outlook suggests a centrist strategy in client portfolios. An absolute approach to value would suggest largely exiting the markets. A pure momentum approach (running with the bulls Pamplona-style) would entail a feast-and-famine return experience for clients. Neither appears appropriate. While markets as a whole appear expensive and riskier than normal, we continue to find stocks of quality businesses that trade at reasonable valuations and present attractive risk-adjusted returns. Hence, we favor a portfolio of such stocks versus bonds relative to "normal" client-specific asset allocations. Within bond portfolios, our credit-oriented approach tilts toward the lower risk of a recession and away from the increasing risk of higher rates.

We will remain vigilant in monitoring the economic and investing environment. Among the factors that might change the current market tenor, higher long-term interest rates are perhaps the least anticipated. Tighter labor markets and recovering commodity prices imply an end to the low inflation of recent years (exhibit 7). Meanwhile, less central bank bond purchases and increased deficit spending mean higher issuance of government debt.

Exhibit 7: New York Fed Underlying Inflation Gauge %



Higher rates would challenge the value proposition of stock and bond markets and would cause a shift in relative performance within those markets from what has recently worked unusually well to what has lagged. Changes to our stock portfolios during 2017 such as trimming exposure to the technology sector to reinvest in lower-valued cyclicals and our continued low-duration stance in bond portfolios bring some resilience to client portfolios should higher rates arrive.

We appreciate working with you and would welcome further discussion of our outlook and the strategy reflected in your portfolio. Please contact us with any questions.

With best wishes for 2018,

Jeffrey E. Bernardo, CFA Neil J. Sullivan, CFA Gregory M. Estes, CFA Frederick M. Blum

Austen P. Cornell, CFA Milena D. Spasova, CFA CIPM Franco Cirelli, CPA CFP®

Chart 1: S&P 500 Index

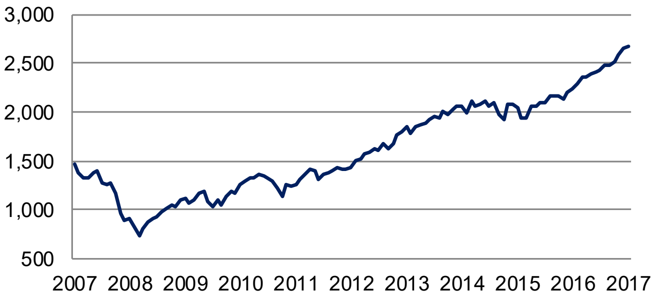


Chart 2: US Treasury 10 Year Yield %

Chart 3: US Annualized GDP Growth %

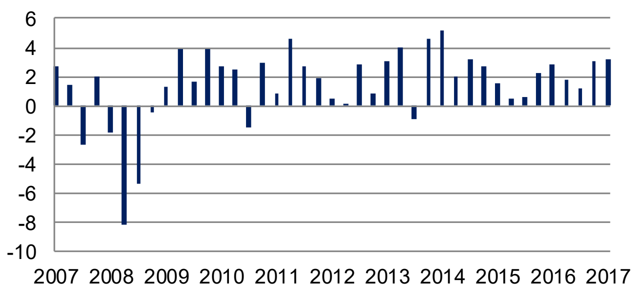


Chart 4: US Core Consumer Price Index %

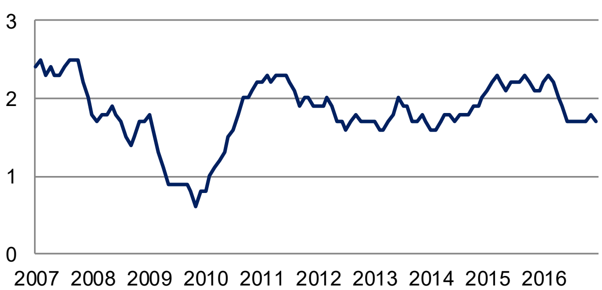


Chart 5: Trade-Weighted US Dollar Index

Chart 6: US Unemployment Rate %

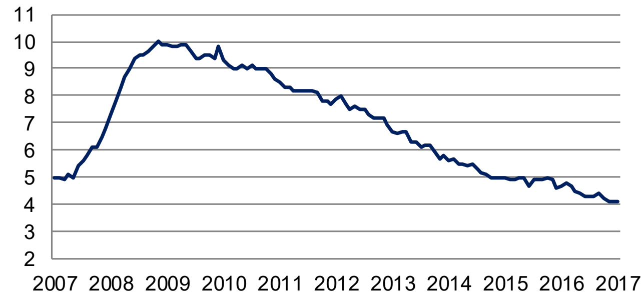


Chart 7: US Consumer Confidence Index

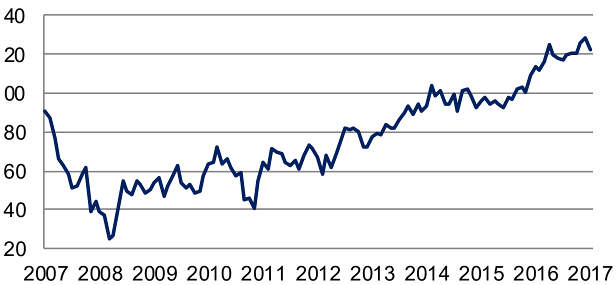


Chart 8: US Retail Sales Growth %

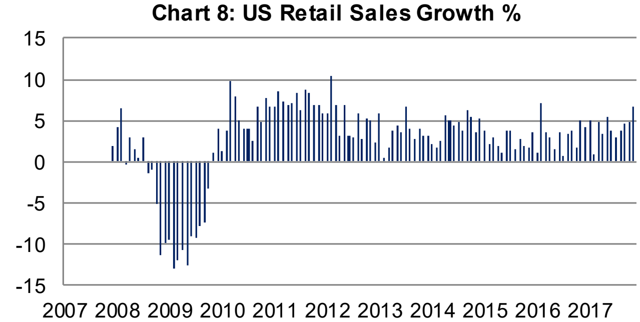


Chart 9: US ISM Manufacturing Index

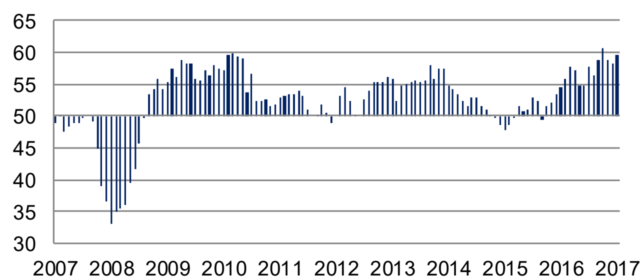


Chart 10: Conference Board Leading Index