

## Fourth Quarter 2017 Commentary

January 13, 2018

Dear Investor,

The fourth quarter ended with markets and the economy packing enough momentum to propel share prices and growth well into the formative months of 2018. Wall Street euphoria over deep tax cuts and deregulation gave way to speculation over whether companies would use their savings to finance share buybacks and dividends or the kind of capital investment that will revive job security and rising wages at a time when full employment coincides with rising household debt and stagnant payrolls.

Beyond the US, developed economies in general and emerging markets in particular are expected to sustain the cycle of synchronized growth thanks to the fumes of quantitative easing - in full reverse in the US, idling in Europe and still in high gear in Japan and China.

### US Markets:

Emblematic of a standout year for listed companies, the Dow Jones Industrial Average set a closing record on December 21, rising 0.6% in response to the White House's tax bill passing into law. It was the average's 70th record close of the year - a record in itself, topping the 69 records that occurred over 1995.

Appraising stocks in isolation of macroeconomic and monetary policy - the so-called "bottom-up approach" - UBS estimated that a 21% corporate tax rate would boost Standard & Poor's 500 earnings-per-share by 9.1%. It also noted that firms expect to buy some \$350 billion of their shares - equal to 1.5% of market capitalization and a larger haul than the \$300 billion in stock repurchases that followed the 2004 tax holiday. UBS also expects a heady increase in M&A and corporate spending as a result of the new law.

A similar view was expressed by Blaine Rollins of 361 Capital, who argued that cashed-up companies, particularly mature ones, will likely invest their tax savings in buying back stock and greater dividends. However, he noted that businesses seeking to establish themselves in new industries and markets in a time of synchronized global GDP growth will need to invest in capital formation, R&D and acquisitions. "If a CEO and Board of

Directors listens to the stock market and cares about their stock price, then they will spend time looking to deploy repatriated capital with the 2018 Tax Bill," according to Rollins.

12/31/2017 Economic and Market Review										
Overall	Indicator Name	Value	1 Mo. Ago		3 Mo. Ago		1 Yr. Ago			
▲	S&P 500 Total Return	5,213	5,145	▲	1.31%	▲	6.64%	4,279	▲	21.83%
▲	Russell 2000 Total Return Index	7,554	7,550	▲	0.05%	▲	3.34%	6,589	▲	14.65%
▲	MSCI EAFE Total Return	8,135	7,940	▲	2.46%	▲	4.27%	6,476	▲	25.62%
▲	MSCI Emerging Markets Total Return	2,522	2,423	▲	4.09%	▲	7.50%	1,831	▲	37.75%
▲	10 Year Treasury Rate	2.40%	2.37%	▲	1.27%	▲	0.84%	2.45%	▼	-2.04%
▲	Barclays US Aggregate Total Return	2,046	2,043	▲	0.17%	▲	0.39%	1,976	▲	3.54%
▼	AMEX Dollar Index	92.30	92.9	▼	-0.64%	▼	-0.83%	102.38	▼	-9.85%
▲	Euro to US Dollar Exchange Rate	1.20	1.19	▲	0.91%	▲	3.05%	1.05	▲	13.77%
▼	US Dollar to Chinese Yuan Exchange Rate	6.51	6.61	▼	-1.62%	▼	-2.21%	6.94	▼	-6.29%
▲	US Dollar to Japanese Yen Exchange Rate	112.69	111.88	▲	0.72%	▲	0.04%	116.78	▼	-3.50%
▲	Gold Price in US Dollars	1,291	1,276	▲	1.22%	▲	1.64%	1,146	▲	12.66%
▲	WTI Crude Oil Spot Price	60.46	58.35	▲	3.62%	▲	11.22%	53.8	▲	12.48%
▼	VIX	11.04	11.43	▼	-3.41%	▲	8.45%	14.04	▼	-21.37%

Source: yCharts

Source: yCharts

Speaking of earnings, FactSet argued that the decline in the bottom-up EPS estimate recorded during the first two months of the fourth quarter was smaller than the one-year, five-year, and 10-year averages. In fact, the fourth quarter of 2017 marked the smallest decline in the bottom-up EPS estimate for the first two months of a quarter since Q2 2011.

JPMorgan proclaimed 2017 the year everyone went “all-in” for stocks as investment portfolios from the household to sovereign-wealth level amassed record allocations of equity. (See chart.) The JPMorgan note warned that such a concentration of stocks implies precarious levels of margin debt at a time where there are no marginal buyers left in the market. “There is only so much the market can rally if equity investors are already near maximal allocations,” according to the bank. Zero-Hedge chimed in: With increasingly more traders and momentum-chasers shifting away from the manipulated arena of stock trading, and on to cryptocurrencies, one can understand why both commercial and central banks hate the best performing asset class of 2017.”

Bond markets moved in divergent directions both in response to rising interest rates and year-end window dressing. The spread between the yields on 2-year and 10-year Treasuries narrowed to 50bps in late-December, the lowest level in nearly a decade and one of the biggest single-session shifts of 2017. At the same time, the \$34 billion sale of 5-year treasuries resulted in a yield of 2.26% - the highest since March 2011 and well above

November's 2.06% - thanks largely to recent Fed tightening. The tepid demand suggested the Fed may soon have to return to the market and monetize more debt in 2018.

**Figure 88: Equity Positioning (Percentile) by Investor Type**  
Historical time periods for %-iles vary based on data availability

<b>Investor Type</b>	<b>Equity %-ile</b>
Margin Debt / Mkt Cap.	100%
US Households	94%
US Mutual Funds	98%
Pensions	88%
Sov. Wealth Funds	100%
Systematic Strategies	100%
All Hedge Funds	98%
Equity Hedge Funds	93%

Source: J.P. Morgan Macro QDS, [report](#)

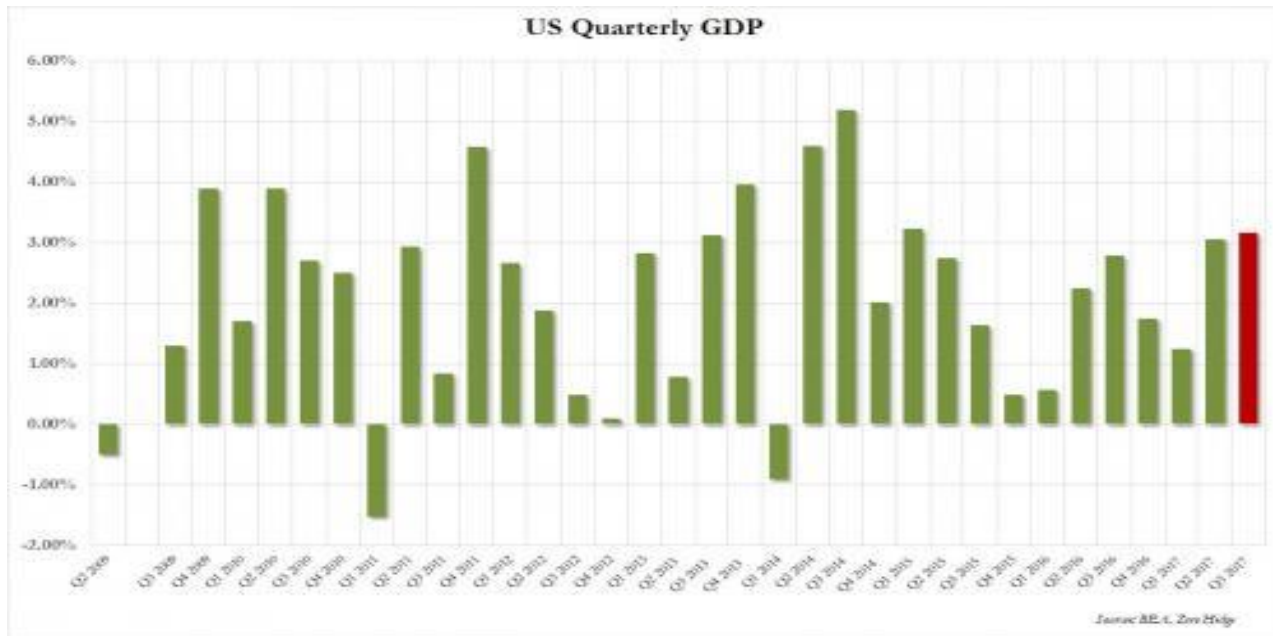
## US Economy:

Growth in the third quarter came in at 3.2%, the fastest clip since 2015 despite minor declines in personal consumption and trade. Growth centers included inventory expansion, capital investment and export sales. Consumer spending rose thanks to purchases of such goods and services as automobiles, health care, financial services and insurance, and the food and beverage sector.

Goldman Sachs forecast slightly stronger growth for the next two years - by 0.3 percentage points in 2018 and again in 2019 - given the front-loaded composition of the tax bill, financial deregulation and continued strong economic momentum. Goldman also lowered its year-end 2018 unemployment rate forecast to 3.5% due to modestly higher expected pace of job growth. However, the bank also forecast the federal deficit would rise to 3.7% of GDP in 2018 and to 5% of GDP next year. "With more fiscal stimulus comes larger deficits," it warned, "and we are increasing our deficit projection somewhat to take the recent tax legislation into account, as well as upcoming spending legislation."

Business sentiment continued to soar, as small business optimism in November reached its highest level since the Reagan administration, according to the National Federation of Independent Business Index of Small Business Optimism. "We haven't seen this kind of optimism in 34 years," said NFIB President and CEO Juanita Duggan. "Small business

owners are exuberant about the economy, and they are ready to lead the U.S. economy in a period of robust growth.” Meanwhile, November Producer Prices beat expectations as PPI Final Demand surged 3.1% on a year-on-year basis, the biggest jump since December 2011. The index for final demand goods jumped 1.0%, the largest advance since a 1.0-percent increase in January.



Credit Writedowns Pro last month estimated that growth levels should sustain themselves so long as initial jobless claims remain at year-ago levels and it forecasted two more quarters of growth beyond 3.0%. “There is no sign in the data that US companies have begun laying off more workers, something that would depress consumer spending, according to the trade journal. “And so given positive forward-looking data regarding new orders in both the manufacturing and services ISM reports, we should expect output to continue to expand at a relatively brisk pace.”

Existing-home sales surged for the third straight month in November and reached their strongest pace in almost 11 years, according to the National Association of Realtors, as all major regions except for the West reported healthy buying and selling. Total existing-home sales - transactions that include single-family homes, townhomes, condominiums and co-ops - rose 5.6 percent to a seasonally adjusted annual rate of \$5.8 million in November from an upwardly revised \$5.50 million in October. Overall, sales are up 3.8% on a year-on-year basis, their strongest pace since December 2006.

Retail sales enjoyed a brisk holiday season. *The Wall Street Journal* reported that retail sales rose 4.9% from the beginning of November through Christmas Eve, its strongest run since 2011, and comes after robust consumer confidence and spending reports. E-Commerce sales rose 18.1%, and analysts expected a fifth of all holiday sales would be done online, led by Amazon.

12/31/2017		Economic and Market Review							
Overall	Indicator Name	Last Reported Date	1 Mo. Ago		3 Mo. Ago	1 Yr. Ago			
			1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change		
▼	US Core Inflation Rate	11/30/2017	1.77%	▼ -3.51%	▲ 1.60%	2.11%	▼ -18.93%		
▲	ADP Change in Nonfarm Payrolls	12/31/2017	185	▲ 34.97%	▲ 160.12%	201	▲ 24.48%		
■	US Unemployment Rate	11/30/2017	4.10%	■ 0.00%	▼ -6.82%	4.60%	▼ -10.87%		
▲	US Producer Price Index: Savings Institutions	11/30/2017	94	▲ 1.17%	▼ -0.63%	93	▲ 2.26%		
▲	ISM Purchasing Managers Index	12/31/2017	58	▲ 2.58%	▼ -1.81%	55	▲ 9.54%		
▲	US Housing Starts	11/30/2017	1,256	▲ 3.26%	▲ 10.67%	1,149	▲ 12.88%		
■	US 30 Year Mortgage Rate	1/4/2018	3.99%	■ 0.00%	▲ 1.27%	4.19%	▼ -4.77%		
▲	US Consumer Price Index	11/30/2017	246.6	▲ 0.39%	▲ 1.05%	242.2	▲ 2.23%		

Source: yCharts

Even as Americans splurged in November, however, the personal savings rate continued to decline. The Department of Commerce reported that the savings rate dove from 3.2% to 2.9% in November, to its lowest level since November 2007. The season's rosy sales were accompanied by tight lending standards and credit card delinquencies, typical of late-cycle consumer behavior and a clear sign that consumers are saving less. The Commerce Department also reported personal income in November rose by a lower-than-expected 0.3%, even as personal spending rose 0.6%, well above the 0.5% expected. According to ZeroHedge, "the 13-week annualized credit card balances in the U.S. have gone completely vertical in the last few months of 2017, a troubling sign and yet another confirmation that US household savings are almost gone, forcing Americans to resort to savings."

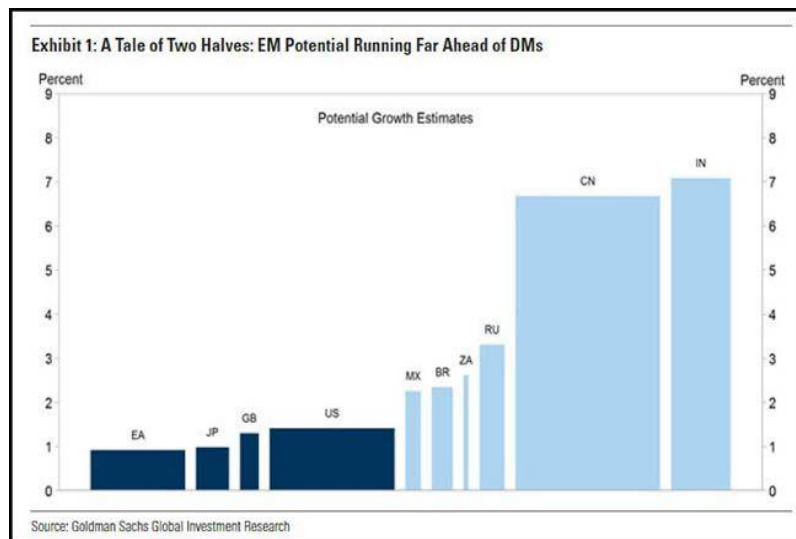
At the same time, the American worker is more productive even as salaries dwindle. According to the Department of Labor, productivity rose 3.0% on a quarter-by-quarter basis in the third quarter, the largest rise since 2014, but it came at the expense of declining worker wages as wages declined by 0.2% against expectations of a 0.2% gain. It was the first straight quarterly slide since 2014. At the same time, real compensation declined on a year-on-year basis, by 1.1%., for the fourth straight quarter. In addition, real average hourly earnings tumbled for the fourth month in a row, its first such string of declines since November 2009.

In a contrarian trend, the WSJ reported that business owners are increasing wages in cities with the tightest labor markets. In what the Journal called "an outcome entirely expected in economic theory," workers in metro areas with the lowest unemployment are experiencing among the strongest wage growth in the country. The labor market in places like Minneapolis, Denver and Fort Myers, Fla., where unemployment rates stand near or even below 3%, has now tightened to a point where businesses are raising pay to attract employees, often from competitors.

# International:

According to the *WSJ*, listed companies worldwide have never been so profitable after a bumper year of earnings growth across global equity markets. The earnings-per-share of a FactSet index of over 20,000 listed companies from around the world has now reached an average \$9.69, the *Journal* reported, increasing 19.0% in the last year.

Emerging markets ended the year resilient, thanks to easy monetary policy and global growth. Ritholtz Wealth Management forecast that currencies and stocks in developing economies are poised for their biggest rallies in eight years “as even the riskiest markets shrugged off various crises and threats to deliver gains for investors.” Goldman Sachs concurred, particularly with regards to large markets. “Notwithstanding the caveat that these [forecasts] are inevitably uncertain — in part because we cannot observe “potential” growth, and also due to the choice of model itself — the main conclusion is that potential growth in the largest EM economies far outstrips that of the leading DMs,” according to Goldman.



As for developed economies, the Bank of Japan announced it was sustaining its aggressive monetary easing and offered no indication it was considering policy changes in 2018. At a two-day policy meeting, the BOJ said it would maintain its short-term interest rate at minus 0.1% and the target for the 10-year government bond yield at around zero as it expects inflation to “likely continue on an uptrend.”

Businesses across the Eurozone ended 2017 on a near seven-year high, according to Reuters, with demand and price pressures heating up and forward-looking indicators signaling a busy start to 2018. Factories enjoyed one of their best months in two decades in December as service activity also accelerated. The upbeat numbers came a month before the European Central Bank was set to cut in half its monthly asset purchases to 30 billion euros.



# Multi-Asset Portfolios

## Attribution Based on Asset Classes

### Equity:

- Positive Contributors: U.S. Large Cap, U.S. Small Cap and Emerging Markets
- Negative Contributors: Non-U.S. Developed

### Fixed Income:

- Positive Contributors: Investment Grade and Mortgage
- Negative Contributors: Emerging Market Bonds and High Yield

### Alternatives:

- Positive Contributors: Frontier Markets and Commodities
- Negative Contributors: Private Equity and REITs

## Portfolio Changes for Multi-Asset Portfolios

During Q4 we increased our exposure to alternatives as well as equity markets in core Europe, the UK and Japan while keeping a safe distance from the siren call of emerging markets. We believe these adjustments will not only protect us from the hazards posed by a later-term cycle but leave us in a position to leverage the aftermath to our advantage. Specifically:

### Equity-Based Changes:

Models impacted: VEGA, VEGA Enhanced, Diversified Equity, Growth, Moderate, Balanced and Conservative

<b>Liquidations:</b>	<b>Reductions:</b>	<b>Additions:</b>	<b>Increases:</b>
SDY	SPY	DBEU	DXJ
HEDJ			HEWG
			DBEM

### Fixed Income-Based Changes:

Models Impacted: Alpha and Conservative Income

<b>Liquidations:</b>		<b>Additions:</b>	<b>Increases:</b>
BAB	DBL	FRA	DPFNX
TOTL	MORT	BSIX	
MPV	HPS	PIMIX	
REM			

## Alternative-Based Changes:

Models Impacted: Diversified Equity, Growth, Moderate, VEGA Core Plus, Balanced, Conservative, Core Fixed Income

<b>Liquidations:</b>	<b>Reductions:</b>	<b>Additions:</b>	<b>Increases:</b>
ARCC	MINT	INNNX	FTLS
VNQ		MAIN	
SPFF		CONE	
		FM	

Going in to 2018 we will continue our ongoing reviews of the STAR Spectrum models that began at our Economic Forum in early December. As always, we appreciate your continued support.

Sincerely,



David Young, CFA  
Chief Investment Officer

## DISCLOSURE

*This commentary is published by Partnervest Advisory Services LLC and is provided free of charge. Any stated or implied recommendations herein are of a general nature. Clients should consult with their investment advisor representative for advice concerning their particular situation and consider their own financial circumstances and goals carefully before investing. The information presented was obtained from sources and data considered to be reliable, but its accuracy and completeness is not guaranteed. It should not be used as a primary basis for making investment decisions. Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not indicators or guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Opinions, beliefs and/or thoughts are as of the date given and are subject to change without notice. Past performance is not indicative of future returns and there is always a risk of loss of principal with any strategy. Due to varying needs and circumstances, allocations and performance of individual accounts may differ from their corresponding model. This commentary is designed to be general in nature and reflects our overall opinion. All asset classes or securities may not be in your particular portfolio nor within the targeted allocations. This is NOT a solicitation for the sale or an offer to buy any security. Indices do not reflect actual portfolios or trading and the stated returns do not include investment management fees, transaction fees, dividends and other earnings and the timing of investment decisions, thus, they are not necessarily indicative of the allocation or return that an actual managed account in the future will or would have achieved. Partnervest strategy performance, if depicted, is net of fees. For additional details on this, or any of the investment strategies offered by Partnervest, please consult your investment Advisor. Investment management services provided through Partnervest Advisory Services LLC. Subadvisory Services and research provided by Anfield Capital Management, LLC.*