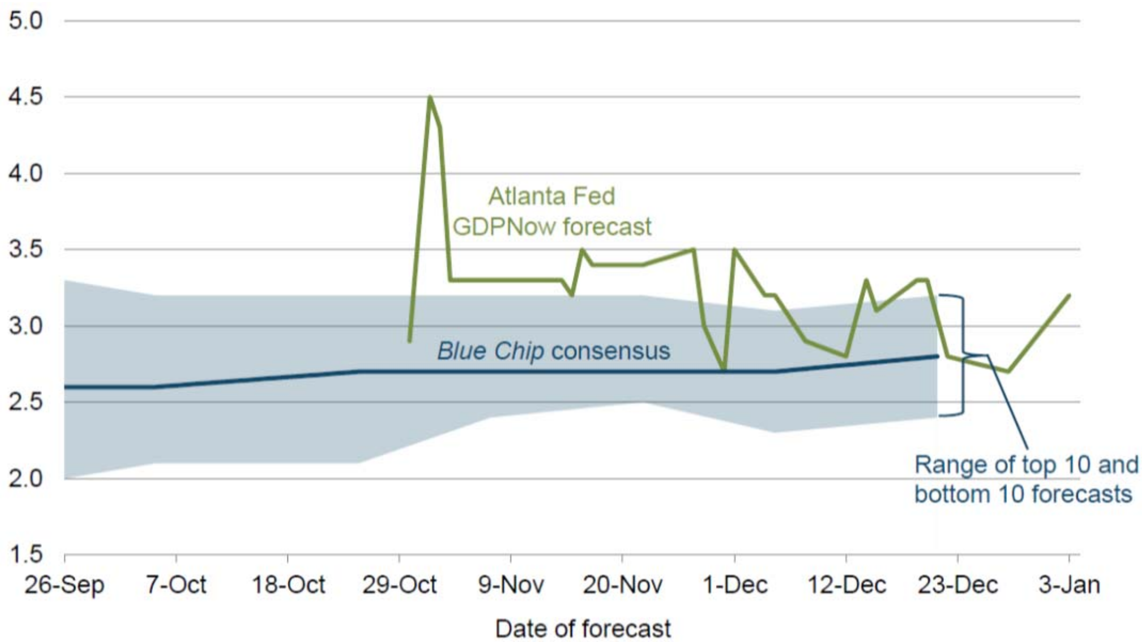
ECONOMIC REVIEW AND OUTLOOK

U.S. Economic growth has accelerated

The economy appears to have significant momentum after posting growth of 3.1% in the second quarter and 3.2% in the third quarter. As illustrated below, growth may exceed 3.0% again in the fourth quarter.

Economists expect the economy to grow at a 2.6% rate in 2018, which is well above the average for this expansion cycle. Economists expect that the new Tax Act will increase growth this year by between 0.1% and 0.4%.



The economy will probably slow in the first quarter of 2018 from the recent strength. The first quarter has typically been weak with a bounce back in the second quarter. The extreme cold weather and excessive snow on the east coast will be a negative factor. And activity around the Tax Act probably pulled spending forward, while paycheck withholding reflecting lower taxes will not show up until late February.

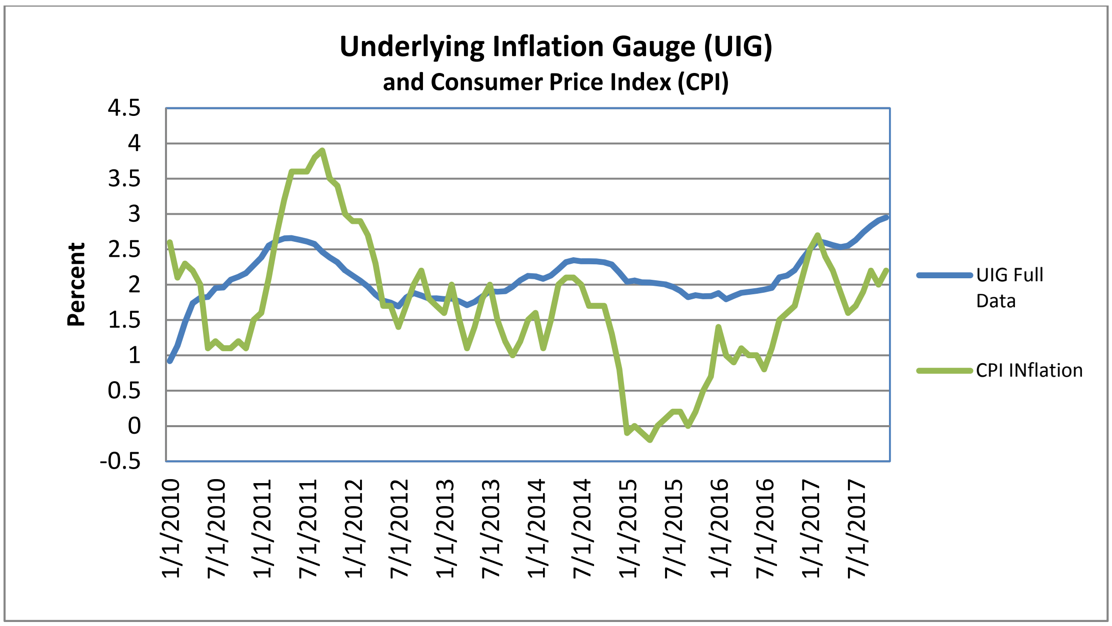
The deflationary secular forces that we have described in the past, for example, demographics, the trade deficit, and technology, are still present. However, consumer and business optimism, a synchronized global expansion, and a recovery in the oil patch are contributing to above trend growth.

The inflation rate is above the Federal Reserve's 2% target

In the graph below, we illustrate a new inflation measure introduced by the New York Federal Reserve Bank last year. This new measure not only takes into consideration the prices of goods but also other inputs such as financial market data, reflecting the trend of sampling large datasets with greater frequency.

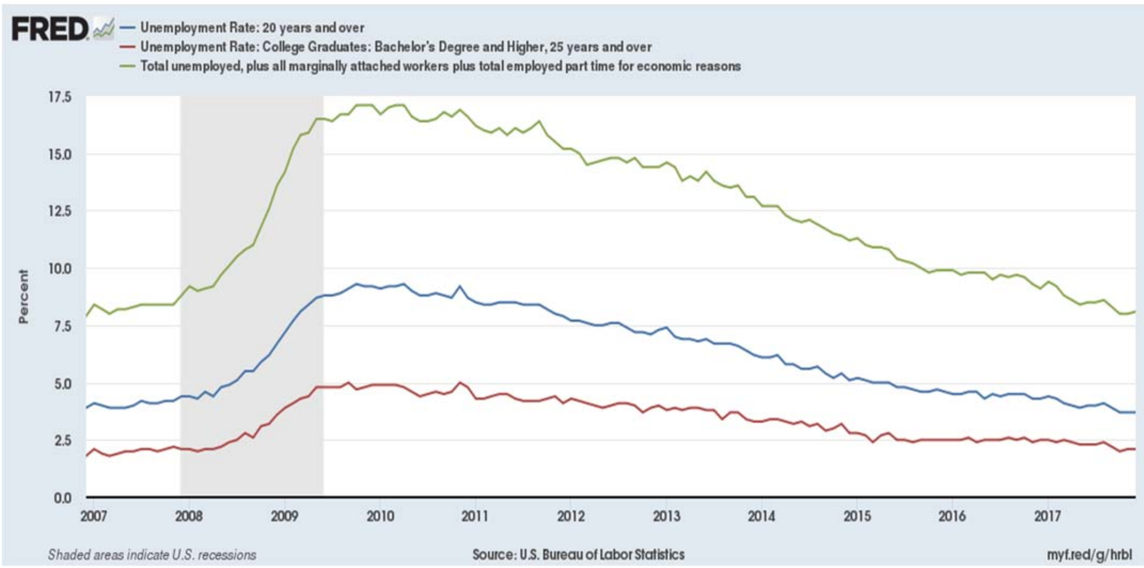
Importantly, the UIG measure is less volatile than the CPI while adding data compared to measures such as the core CPI that remove food and energy prices. Furthermore, the UIG tends to be a better measure of trend inflation and is more predictive of future inflation.

The UIG is signaling a higher level of inflation than is reflected in expectations or the financial markets.



The labor market has fully recovered

The unemployment rate reached 4.1% in the 4th quarter. The last time the unemployment rate was lower was December of 2000, when the unemployment rate was 3.9%. The employment to population ratio has also gained. This measure suggests that the tight labor market is drawing in people that were not previously looking for work.



The unemployment rate should decline further. However, the pace of job creation should slow because of the difficulty of finding qualified applicants. For example, 85% of small businesses that reported hiring or trying to hire reported few or no qualified applicants. Thus, the monthly employment report, a closely watched economic release that highlights the number of jobs created, has slowed from 230,000 per month in 2015, to 190,000 per month in 2016, and to 170,000 per month in 2017.

Tight labor markets and incentives in the new Tax Act should spur capital investment into equipment and technologies that are less labor-intensive. Although business investment has been lackluster in this recovery cycle, we expect an increase similar to past business cycles.

INVESTMENT STRATEGY

Allocation: Our overall allocation strategy is defensive because of high valuations of both stocks and bonds. High valuations imply low returns over an extended time period and/or large declines. Thus, we are under-weighting stocks. We are lowering bond allocations. Higher cash yields make cash a more viable alternative to bonds, if rates rise.

Stock Market Gauge: Our stock market gauge is neutral with a 3.2 reading. Poor valuation and overly bullish sentiment, which are at readings of 1, are offset by strong earnings and momentum readings of 5. Liquidity is still supportive with a value of 4.

Value Stocks: We think that value stocks will outperform this year as investors focus more on the acceleration of growth as well as an increase in interest rates. Value stocks, which represent “cheap” stocks, are concentrated in financials, energy, and more economically sensitive companies. Financials and energy companies should benefit the most from the Tax Act, since they have high corporate tax rates. Financials also benefit from higher interest rates and stock market values. Finally, our analysis of past periods suggests that value stocks can out-perform so-called growth stocks because the valuation difference is at an extreme and length of the cycle is consistent with past cycles.

Quality Stocks: Quality stocks represent ballast in the stock portfolio. They probably will not out-perform unless stocks correct. After two years of double digit gains, a slowing earnings growth cycle, and a period of unusually low volatility, the chances of a correction have increased.

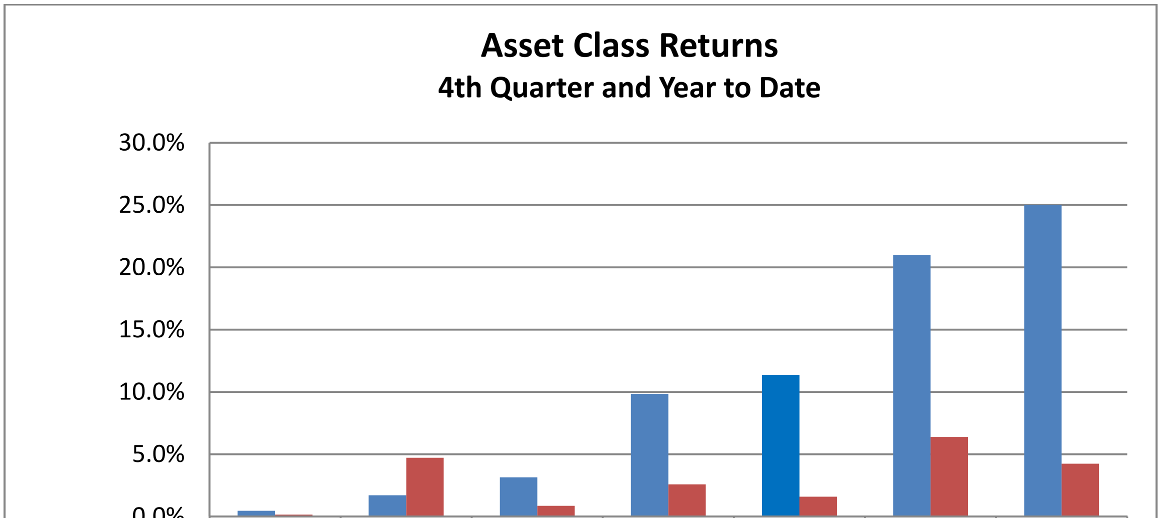
International Stocks: International stocks have under-performed U.S. stocks for an extended period, resulting in a large valuation gap, as we have illustrated in the past. The U.S. stock market recovered earlier than foreign markets because the U.S. undertook stimulus efforts before the rest of the developed world. Furthermore, more successful economic policies tended to support a higher Dollar. Prospectively, higher relative growth overseas should support foreign currencies.

Bonds: Strong growth, no recession in sight and above expectation inflation imply a hostile environment for bonds. Despite increasing growth, inflation and economic enthusiasm last year interest rates were flat to down last year. Thus, it seems likely that the economic realities will catch up with bonds, pushing up rates and depressing prices. Furthermore, investors have focused on the 2.4% to 2.6% level for the U.S. Government 10 year treasury. This range represents breaks in various trend lines for this cycle as well as since the early 1980’s. Thus, both the fundamentals as well as the technical sentiment appear to be negative for bonds.

All Assets Classes Gained in the Fourth Quarter and the Year

Stocks rallied to new highs as earnings gains and economic optimism supported an "all clear" view of the markets. Continued demand for bonds allowed bonds to rally in the face of economic strength. Commodities also gained in the quarter, boosted by strength in global manufacturing demand.

After a weak year for all asset classes in 2015, all asset classes gained in 2016, and most asset classes had even larger gains in 2017, with the exception of commodities, where an 11.8% return was followed up last year with a paltry 1.7% return.

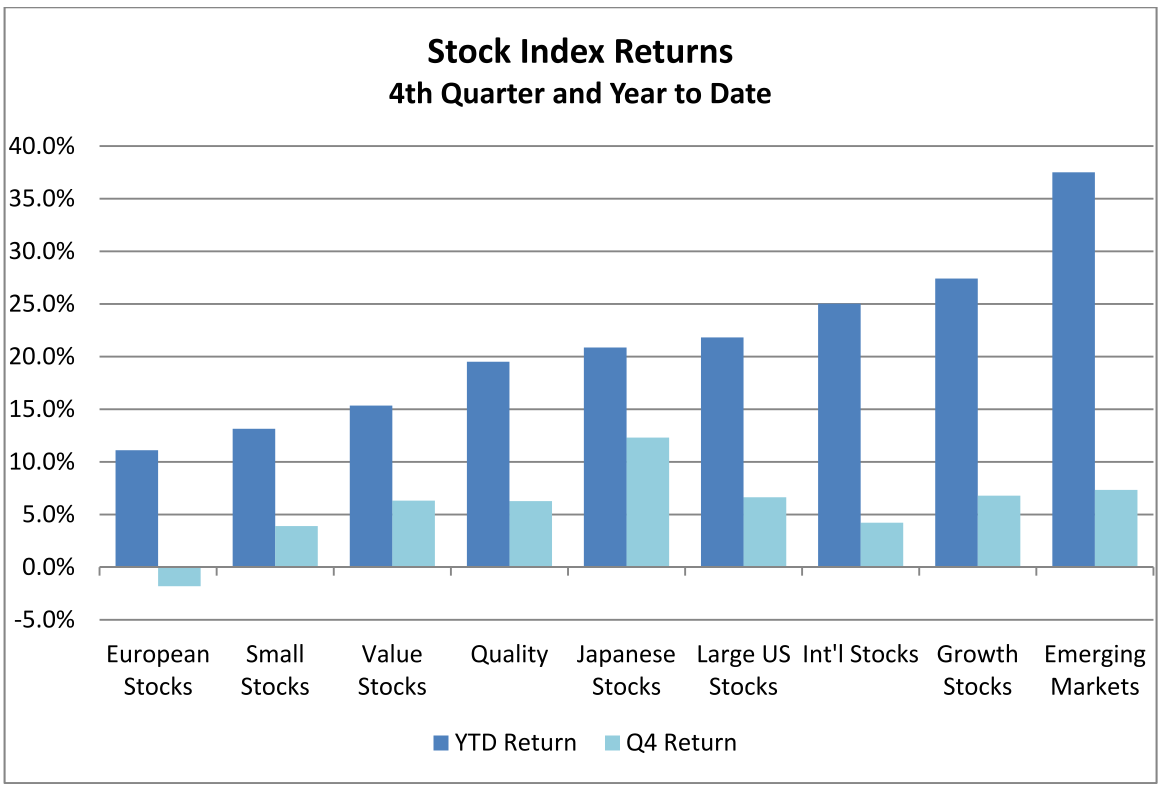


	Cash	Commodities	US Bonds	Real Estate	Int'l Bonds	US Stocks	Int'l Stocks
YTD Return	0.5%	1.7%	3.1%	9.8%	11.3%	21.0%	25.0%
Q4 Return	0.1%	4.7%	0.9%	2.6%	1.6%	6.4%	4.2%

Stocks Continue to Post Strong Gains

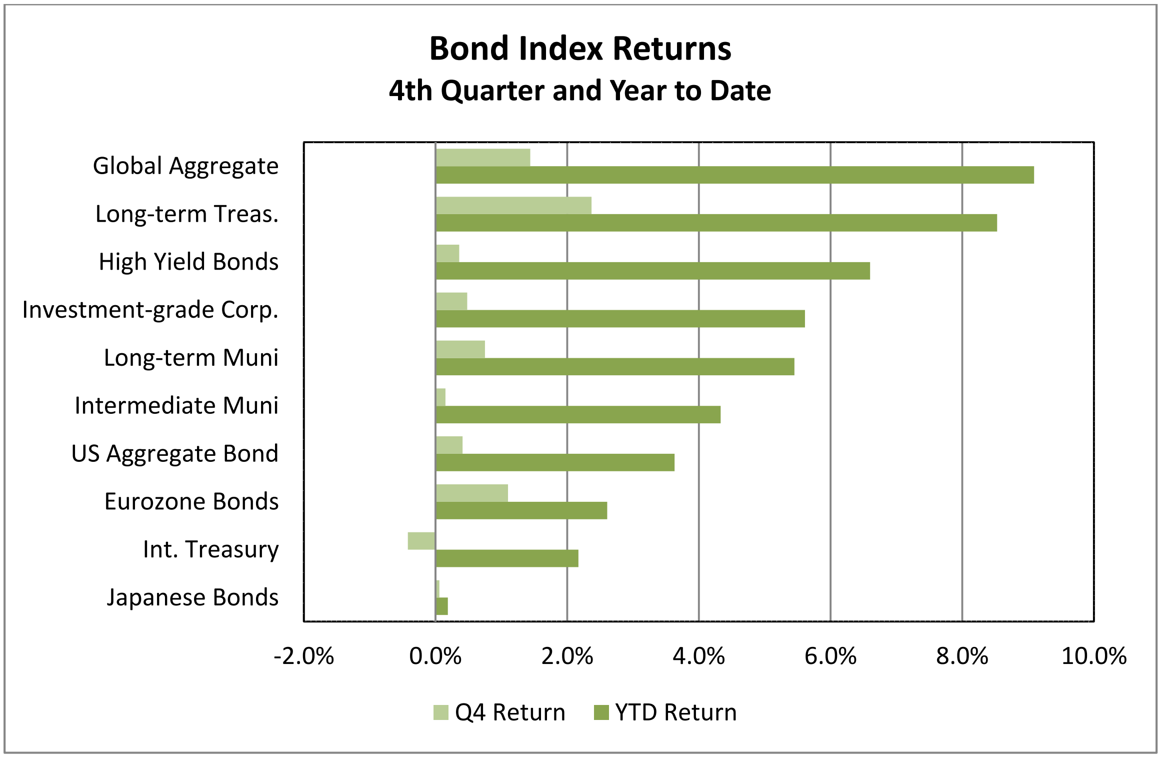
International stocks gained 25% for the year, after a fourth quarter return of 4.2%. U.S. stocks returned 21% and 6.4%, respectively. Emerging market stocks were the belle of the ball, gaining 37.5% for the year. However, losses in the value of the U.S. Dollar, a decline of approximately 8.5%, accounted for all of the international stock *out-performance* and then some.

As noted last quarter, domestically, growth and momentum dominated last year with market beating returns. “Growth” is somewhat of a misnomer because growth indices actually represent the most expensive companies on a price to book value basis; nonetheless, many expensive stocks are growing rapidly. Momentum refers to a strategy of buying what has been going up the most. Companies with attractive valuations (value), the most profitable companies (quality), and dividend paying companies trailed the broad market indices.

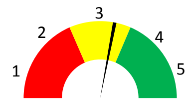


Demand for Income Buoys Bond Prices

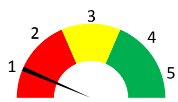
Bond prices made small gains in most categories as investors shrugged off Federal Reserve plans to raise rates, as well as growing evidence of solid global growth, which would be expected to put upward pressure on rates (and downward pressure on bond prices). Income on bonds accounted for much of the return in the quarter.



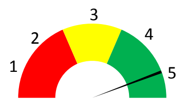
STOCK MARKET DASHBOARD



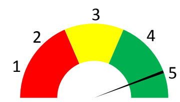
Overall Market Gauge
3.2



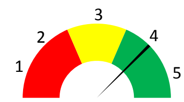
Valuation



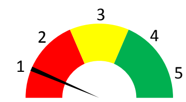
Earnings



Momentum



Liquidity



Sentiment