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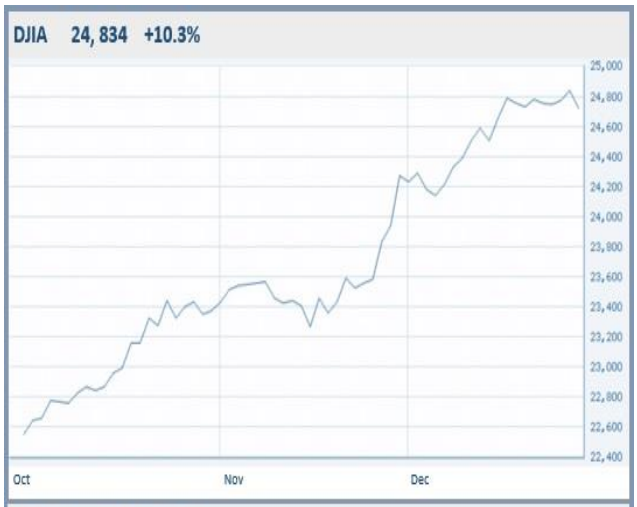
Quarterly Economic Update - Fourth Quarter 2017

While the weather in the United States ended 2017 on a cold note for many residents, equity investors finished a very warm year. 2017 was a great year for investors as strong returns pushed domestic equities to fresh all-time highs. Robust equity performance was also seen across many of the major global indices. Most fixed income sectors posted healthy gains as well. The positive performance of equity markets in 2017 added to what is already one of the longest bull markets on record.

At year end, equity markets rallied on the news of tax reform, with big permanent cuts for corporations as the centerpiece of the new tax package. The S&P 500 ended a strong year with a fourth-quarter gain of 6.1%. The Dow Jones Industrial Average also ended the quarter with a strong gain of 10.3%.

In December, the Fed raised interest rates once again by 0.25%, elevating the U.S. Federal Funds rate range to 1.25% - 1.50%. The Fed has also forecasted another three rate hikes in 2018 and two hikes in 2019, however, this has not stopped equities from roaring to historic highs.



MONEY RATES

(as posted in Barron's 1/1/2018)

	LATEST WEEK	YR AGO
Fed Funds Rate (Avg. weekly auction -c)	1.42%	0.66%
Bank Money Market -z	0.14%	0.11%
12-month Cert -z	0.42%	0.31%

c- Annualized yields, adjusted for constant maturity, reported by the Fed Reserve on a weekly average basis. z – Bankrate.com (Source: Barron's; bankrate.com)

Longer term interest rates stayed reasonably low again in 2017 and *Kiplinger's* noted in their late December interest rate forecast that they think the approximately 2.5% yield on the 10-year Treasury note will hit 3.0% by the end of 2018.

On the political front, 2017 was both chaotic and surprising, but it ended with a major piece of tax legislation getting passed. Additionally, 2017 will also be remembered for its natural disasters as there were an astounding 16, billion-dollar events in 2017.

A Review of 2017 Equity Returns

The year's strong returns came with an environment of very low volatility. In fact, the S&P 500 posted positive total returns in every month of the 2017 calendar year. According to *Seeking Alpha*,

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in a data set stretching back 90 years, this is the first calendar year without a monthly loss for the S&P 500.

Many times, investors use the S&P 500 as a benchmark for overall equity market returns. For the year, the S&P 500 was up 22%, led by its largest sector weight, Technology, up 35%. Financials, Healthcare, Industrials, Materials and Consumer Discretionary all rose by more than 20%. The only two sectors down last year were Energy and Telecom, down 1% and 8% respectively. One interesting fact that sometimes gets overlooked is that the Energy sector was the single best performing sector for the market in 2016.

Sometimes investors wonder - why is the S&P 500 up more than my portfolio?

Please remember that a "straight-up" comparison of returns is of little value to most investors. Diversified investors use income instruments and some cash-equivalents, so only a portion of their portfolio is actually exposed to trading risk. To simply compare your returns to index returns ignores your actual risk tolerance. Risk is simply the potential amount one can lose if things go wrong. Diversified investors use "calculated risk" which is looking at your potential risk given the most probable outcome. Most investors should try to minimize risk as much as possible and be willing to undertake only calculated risk.

Although they add less return, low return cash equivalents and income vehicles provide less volatility and stress. Before being tempted to fully allocate into potentially higher returning stocks, investors need to remember that during the 2000 to 2002 bear market, the S&P 500 fell by 49.1%. Also, during the Financial Crisis of 2007 to early 2009, the S&P 500 fell 56.8%. Sometimes investors can change their allocations, but many times it cannot be done with limited risk.

Overall 2017 was a good year for investors. **If you would like to revisit your specific holdings or risk tolerance please call our office or bring it up at our next scheduled meeting.**

2018 Outlook

Many analysts feel that the recently passed tax bill is likely to stimulate the stock market and the economy in 2018.

Key Points

1. **Q4 finished 2017 with robust returns for equity investors.**
2. **2017 is the first calendar year in 90 years without a monthly loss in the S&P 500, continuing one of the longest bull markets on record.**
3. **The Fed raised U.S. Fed Fund rates to 1.25 - 1.50% in December and set to raise rates three more times in 2018.**
4. **Analysts suggest 2018 will have positive but much lower returns.**
5. **Investors need to still be cautious and watchful.**
6. **Focus on your personal goals and call us with any concerns.**

Reported employment numbers are strong and another driving factor for the economy is the current health of the housing market. A new year once again brings crystal ball time for Wall Street stock strategists.

A *USA TODAY* analysis of more than a dozen 2018 predictions made by Wall Street's biggest banks found a wide variation in their opinions of where stocks are headed. The most bullish year-end price target for the S&P 500 is a rise of 16%. The least optimistic prediction is a gain of less than 3%. The average target is a return of roughly 7.5%.

Barron's writes that, "Given synchronized global growth and rising corporate profits, 2018 could be another good year for stocks, notwithstanding the bull's advancing age. The S&P 500 could gain about 7%, mirroring similar gains in corporate profits, according to the consensus forecast of 10 investment strategists at major U.S. investment banks and money-management firms surveyed by *Barron's* each December."

That said, year-end predictions are more of an estimated guess than science. Predicting the future is never an exact skill. For example, at the start of 2017 not a single strategist at 18 top banks saw the Standard & Poor's 500 stock index rising as much as it did. The average gain predicted was 5.5% and the biggest bull saw stocks rising 12%, according to *Bloomberg*.

All Eyes on Interest Rates

U.S. Federal Reserve policymakers showed "worry over the fate of currently low inflation." They also felt recent tax changes would provide a boost to consumer spending, according to the minutes of the U.S. Central Bank's last policy meeting of the year.

"2018 will be another year with an active Federal Reserve," says Greg McBride, CFA, Bankrate's Chief Financial Analyst. He also added that 2018 would be a year in which we will see, "inflation pick up but stay near 2 percent, a further flattening of the yield curve, faster but uneven economic growth, and an overdue stock market correction — though the actual cause of the correction will be anyone's guess."

At its December meeting, the Fed kept its forecast for rate rises in 2018 and 2019 unchanged even as policymakers anticipated a short-term boost in U.S. economic growth from the Trump administration's tax bill which was signed into law on Dec. 22. For 2018, Jerome Powell is set to take over for Fed Chair Janet Yellen by the time of the next rate-setting meeting on January 31 – February 1.

Interest rates are a key area that we will watch closely in 2018.

Conclusion:
What should an investor consider?

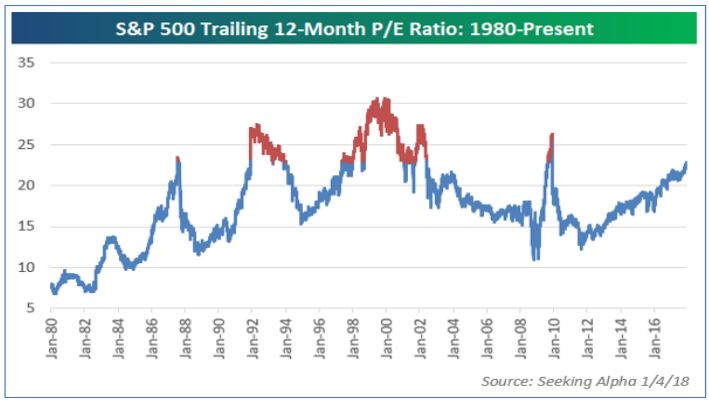
While many things appear to be lined up in 2018, there is always the chance that something can go wrong. While most analysts remain optimistic, the market has already staged a strong run stretching back to March 2009. Investors with extremely long time horizons of 20 to 30 years or longer can many times accept more risk than those with shorter horizons. In their *2018 Investment Outlook*, Credit Suisse writes, "Financial markets have again proven resilient to geopolitical shocks in 2017. With growth robust, inflation moderate and liquidity ample, interest rates should slowly rise. Equities should make further gains in 2018." Their investor takeaway is, "With growth robust and bond yields seen as rising gradually, equities are expected to outperform bonds in 2018." *(Source: Credit Suisse 2018 Outlook)*

Russell Investments' global team of investment strategists in their *2018 Global Market Outlook* believes that global growth momentum is likely to persist into 2018, pushing up equity markets over the first part of the year.

Barron's reports that, "while all our strategists expect stocks to head higher in 2018, some see a yellow light, not a green one, suggesting that the bull's days are numbered." *(Source: Barron's 12/9/2017)*

Proceed with CAUTION
is still the principal notion for investors.

As the S&P 500 climbs higher and higher, its trailing 12-month Price Earnings (P/E) ratio continues to climb as well.



Bespoke warns that at year end, the S&P 500's 12-month P/E is just a hair below 23. Some analysts are concerned that by this measure, equity evaluations have become "expensive". The chart in this report shows the S&P 500's P/E ratio going back to 1980. The line is red when the P/E ratio is above the level it's at right now. As the chart shows, there have only been a few periods since 1980 where the index's P/E was higher than it is currently. While valuations are indeed elevated right now, please note that analysts warn that high valuations alone are not a catalyst for corrections or bear markets.

With the S&P 500 trading well above its historical average of 15 times earnings, "it is accepted wisdom that the market is expensive," says Stephen Auth, Chief Investment Officer for equities at Federated Global Investment Management. However, he argues that currently that is not the case, given the economic and interest-rate backdrop, a pro-business administration, and unattractive fixed-income alternatives.

What should investors do?

Full market risk is not appropriate for most investors and today's traditional fixed rates might not help many investors to achieve their desired goals. Most investors attempt to build a plan that includes risk awareness. Many times this can lead to safer but lower returns. Traditionally, bonds have been used as a nice hedge against market risk, but with interest rates projected to rise, investors need to be extremely cautious.

For 2018, let's focus on YOUR personal goals and Strategy.

Investors need to be prepared. Market volatility should cause concern, but panic is not a plan. Market downturns do happen and so do recoveries. This is the ideal time to ensure that you fully understand your time horizons, goals and risk tolerances. Looking at your entire picture can be a helpful exercise in determining your strategy.

We focus on your own personal objectives. During confusing times, it is always wise to create realistic time horizons and return expectations for your own personal situation and to adjust your investments accordingly.

Now is the time to make sure you are comfortable with your investments.

Equity markets will continue to move up and down. Even if your time horizons are long, you could see some short-term downward movements in your portfolios. Make sure your investing plan is centered on your personal goals and timelines. Peaks and valleys have always been a part of financial markets and is highly likely that trend will continue.

Discuss any concerns with us.

Our advice is not one-size-fits-all. We will always consider your feelings about risk and the markets and review your unique financial situation when making recommendations. **If you would like to revisit your specific holdings or risk tolerance please call our office or bring it up at our next scheduled meeting.**

We pride ourselves in offering:

- ✓ consistent and strong communication,
- ✓ a schedule of regular client meetings, and
- ✓ continuing education for every member of our team on the issues that affect our clients.

A skilled financial advisor can help make your journey easier. Our goal is to understand your needs and then try to create a plan to address those needs. Should you need to discuss your investments, please call us.

Please share this report with others!

This year, our goal is to offer services to several other clients just like you! If you would like to share this report with a friend or colleague, please call (215) 886-2122 and we would be happy to assist you!

Sources: Barron's, Seeking Alpha, Blackrock; Bespoke; Kiplinger; Bloomberg; USAToday: Bankrate.com; ©

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