2017 Market Review & 2018 Outlook

2017 Economic & Market Review/Comments

Global stock markets in the United States and around the world enjoyed a historically good year. Although returns were excellent, with the S&P500 up 21.8% for the year and foreign stocks performing even better, the lack of volatility was what stood out. **2017 was the least volatile year in stock market history**; with the largest pullback being a paltry 3%. Despite the unconventional and volatile political climate, North Korea threatening attack, and three major US hurricane strikes, the global stock markets shrugged all these concerns off and concentrated on what matters most to financial markets; the economy and corporate earnings.

US Corporate earnings (S&P500) will be up about 25% in 2017, and GDP growth has been averaging 3% since early last year. **As long as corporate earnings and the global economy continue to grow, all the scary headlines do not matter.**

The 10-year Treasury yield had a quiet year, with interest rates essentially unchanged in 2017 at 2.45%. Yields briefly neared 2% in the middle of last year as the prospect for tax reform waned, but as prospects for growth returned rates inched back up. With longer-term rates unchanged, most bonds simply returned their coupon payments.

Select 2017 Asset Class Returns	
MSCI Emerging Market (Emerging Stock Market)	+ 36.6%
MSCI EAFE (Foreign Developed Stock Market)	+ 25.0%
S&P 500 (US Stock Market)	+ 21.8%
All Asset Risk Variance (AVRPX)	+ 11.0%
DJ US Real Estate (US Real Estate)	+ 9.3%
High Yield Bonds	+ 6.1%
Alternative Lending (LENDX/RMPLX)	+ 6.0%
S&P GSCI (Broad Commodity Market)	+ 4.2%
US Mid/Long Treasury Bonds	+ 2.5%
Insurance Linked Securities	- 9.3%

Even as longer-term rates were flat, short-term rates increased as the FED hiked rates three times during the year. Cash and short-term bonds still sport relatively low rates, however they are at levels not seen since 2008.

It is expected that the FED will hike rates another 3 times during 2018, and if that turns out to be correct, we can see cash and short term bond yields approaching 2%. With the SP500's dividend yield now at 1.7%, it is possible cash and other guaranteed investments can produce more income than the stock market. This is significant, as it could encourage some investors seeking income to move out of stocks and real estate and into lower risk investments for the first time in years.

During 2017, the SP500 ranged from a low of 2277 to start the year to a then all-time record high of 2674 to end the year. This climb through the year occurred in a near straight line with record low volatility and a couple of very small drawdowns. **Volatility (measured by the VIX)** approached 15 only twice, but spent the majority of the time between 9 and 11. **Historically the average VIX level has been close to 20.**

Our alternative suite had a mixed year with a poor year in ILS (insurance securities) and a good year in alternative lending and AVRPX (option selling strategy). As we communicated throughout the year, the three hurricanes and California wildfires caused the first down year in ILS since we entered the space in 2013. Our ILS allocation ended the year down 9.3%. Our alternative lending funds performed as expected with essentially no volatility and returns of 6% and AVRPX had a great year, up almost 11%.

We allocated to the private equity and real estate strategies late in 2017 for qualified clients, and will begin to evaluate the performance of those funds starting January 2018. For most clients, dividends from the GPB private equity fund have already started, and many will receive their first partial private real estate distribution within two months.

After many years, 2017 was finally one of foreign stock outperformance. For a while we have seen superior valuations, higher growth, and higher dividend yields in foreign stock markets. In 2017, with the help of a falling US Dollar, these positive attributes showed up in actual performance.

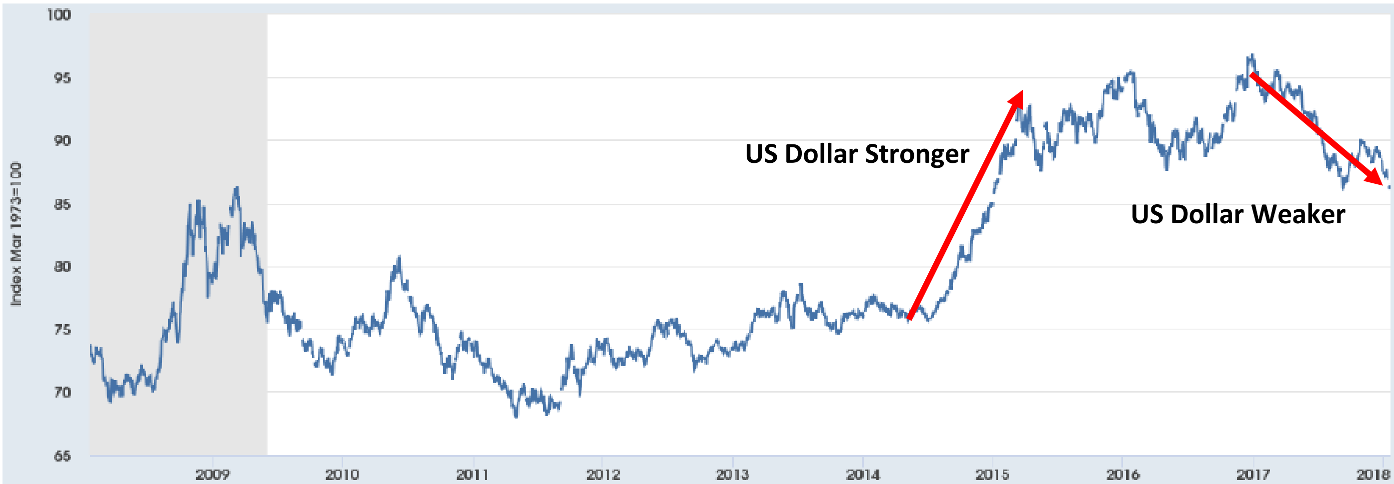
Even though foreign stocks outperformed their US counterparts significantly in 2017, we think there is more room to go. If we expand the timeframe further out, **foreign assets still have a long way to go to catch up.** Since 2010, the US stock market is up almost 200%, while foreign developed stocks are up 66% and emerging markets only up 40%.

Below: Chart of US Stocks (Red), Foreign Developed (Purple), and emerging (Green) in 2017.

The major factors which affected markets in 2017 are highlighted below:

- **FED Rate Hiking/Balance Sheet Reduction:** After nearly ten years of essentially no earnings on cash and short term bonds, quantitative easing, and other government support, the FED began to take the 'training wheels' off the markets and economy in 2017. They hiked the Fed Funds Rate three times to just over 1% from near 0.4% at the beginning of the year. It is expected they will continue to hike rates through 2018 with a robust economy supporting them. Depending on what longer rates do, this could cause a flattening of the yield curve. If we get a very flat or even inverted curve (meaning short-term rates are similar or higher than longer term) this would be a significant red flag in predicting a recession. We are not concerned yet; but are monitoring this closely.

- **US Dollar Decline:** Currencies are extremely hard to predict, but they influence the prices of commodities and all foreign assets significantly. After years of US Dollar strengthening vs. most foreign currencies (especially emerging markets), 2017 reversed this trend with the Dollar decreasing in value vs. a basket of others by just over 9%. To a US investor this equates to at least a 9% increase in returns over the same domestic asset (all else equal). This impact is magnified with emerging market assets. We see no sign yet of this trend stopping, as most major currency moves take place over 2-4+ years. **Below is a chart of the US Dollar index over the past 10 years.**



- **Three Major Hurricanes/Wildfires:** Although the hurricanes and wildfires had little longer term broad based impact on the economy or financial markets, they did significantly effect the reinsurance industry and our allocation to insurance linked securities. 2015 & 2017 are good years to look at the benefits of diversification in regards to ILS and stocks. In 2015 all asset classes were either flat or down with the exception of ILS (which was up 9%). In 2017, stocks and almost all other asset classes were up nicely, with ILS down a little over 9%. This produces a much more stable portfolio through the years and good rebalancing opportunities, along with no sacrifice of returns. Going into 2018 we expect 10% - 15% higher insurance premiums, which *(assuming a normal loss year)* should translate into returns between 9% – 11%.

- **Tax Reform Passage, Increase in Business Confidence, & Deregulation:** As your portfolio manager it is our job to ignore any political biases or personal feelings and invest based on what we are seeing in the markets in terms of fundamentals and factual data points. The continued push for deregulation, generally friendly atmosphere for business, and especially the late year passage of the largest tax cut/reform bill in more than 30 years proved to be extremely positive in 2017. We expect this combination of factors to continue to provide tailwinds to stocks and economic growth through 2018. **We expect corporate tax reform alone to add somewhere in the $3 - $4T+ range to the economy this year and around $750B every year thereafter.** In addition, many individuals will see significant tax cuts of $1,000 - $3,000 per household. This could support increased consumer spending over the next couple years.

Traphagen 2017 Portfolio Comments & 2018 Changes

Overall, we were pleased with how our client portfolios performed in 2017. **All portfolios had good absolute returns between 5% and 15%.** Risk adjusted returns vs. the SP500 varied from good for more conservative/middle of road portfolios, to moderately below targets on more aggressive portfolios**.** Although we always try to at least meet our risk-adjusted portfolio targets, there will be years we lag and years we outperform. **Largely due to ILS we came in under targets for more aggressive portfolios in 2017, but we fully expect to make that up and more through a full bull/bear cycle.**

You will find a summary of major changes we made to portfolios during 2017 and our comments on each investment.

- **Reduction in Insurance Linked Security exposure & partial allocation to Pioneer Fund:** Although we were still negatively impacted by our ILS exposure after years of ~ 8-9% average returns, we did trim our exposure to the asset class early in 2017 (before the hurricanes) by around 30%. This trim, in combination with a partial switch from Stone Ridge to Pioneer, **resulted in significantly lower impacts from the hurricanes on an overall client portfolio.**

- **Increase in Emerging Markets Exposure (JP Morgan Factor ETFs):** We increased our exposure to emerging market allocation twice last year, once in late January and again in the summer. Emerging markets outperformed through the rest of 2017 and the trend continues so far in 2018. We already had a sizeable weight in the asset class coming into 2017, but decided, given trends we saw at the time to increase allocation. We hold two funds in the space (JPEM; up 29% in 2017 and IEMG; up 37% in 2017).

- **Reduction in Managed Futures:** We eliminated managed futures in all aggressive accounts and reduced positions within conservative accounts. We still like the asset class as a risk reducer in more conservative portfolios, but do not feel they are needed for more risk tolerant investors with our large alternative allocation. LFMAX, our only holding in the space was up 2.5% last year, and is up more than 3% so far in 2018.

- **Introduction of Private Real Estate Credit & Equity:** Most qualified clients purchased the GPB Capital private equity fund between July and November and the private real estate credit fund before year-end. We are excited about both these investments from a volatility reduction, dividend, and total return stand-point. In 2018 all invested clients should be receiving significant cash flows from both positions.

2018 Portfolio & Economic Commentary

We continue to hold little or no cash, as it yields less than 1% in nominal terms and around -1% in real terms. If the FED continues to hike rates this year and we approach 2% in yield from cash, we could actively allocate to money markets for the first time since 2009. We remain fairly constructive on the global stock market in the short to intermediate term (6-12 months) as commodities look strong, unemployment is very low, tax reform and deregulation are spurring confidence in the US, and there is wide spread global growth. We currently view early and mid 2018 as the 'sweet spot' for the markets and the economy. If interest rates and inflation increase in conjunction with a market that continues to go up in value significantly we could start to 'overheat'. We are monitoring this closely, but we are not there yet and see this more as a 2019/2020 risk than a 2018 concern.

2018 Portfolio Changes
Trim of High Yield Bonds
Reduction of Investment Grade and Treasury Bonds
Increase in Inflation Protected Bonds (TIPS)
Introduction of a new IShares Factor Fund (LRGF)
Reallocation within commodities (sell 'RSNRX'; buy 'HAP')
Increase in US Small Cap Stocks (overweight to value)

The two main themes regarding the above 2018 portfolio changes are **1)** protecting the portfolio from rising interest rates and **2)** taking advantage of relative value in small cap US stocks and commodities in conjunction with US tax reform and increased growth.

When looking at the short to intermediate term outlook on the US and global economy it is tough to be anything but positive. Unemployment continues to remain very low, with the latest reading just above 4%. Overall US GDP growth has averaged 3% over the past 3 quarters with a strong possibility of similar numbers through 2018. After-tax corporate profits are poised to increase by around 10% from 2017 to 2018, and business confidence is at levels not seen since 2006 - 2007.

All the above factors point to higher commodity prices, higher global growth and increasing inflation and interest rates. The reduction of higher quality/interest rate sensitive bonds in portfolios and a switch into TIPS reflects this.

In addition, after years of underperformance for small cap and value stocks we see a good entry point here. As a kicker, a significant portion of these pieces of the market are financials, industrials, and energy stocks geared more domestically. These should be some of the bigger beneficiaries of tax reform and increased growth.

Our biggest concern we have in the intermediate term, is continued above normal historical valuations in the US stock and bond markets. This should not be a huge problem in the shorter term unless and until we see much higher interest rates. We continue to monitor valuations of all asset classes and diversify portfolios accordingly.

Below we have highlighted what we feel will be the biggest factors for markets and the economy in 2018.

Main Market/Economic Drivers for 2018
Pace of Fed Interest Rate Hikes / Balance Sheet Reductions
US Dollar Direction and Magnitude of Move
Higher GDP growth, Inflation, and interest rates
Possible positive moves in energy/natural resource stocks
Look for higher volatility & material stock correction

Even though we see a generally rosy picture for the US and global economies over the next 9 – 12 months, we also are aware *you have to be wary when things seem too good*. We very well might be having a very different conversation next year at this time if inflation and interest rates are significantly higher, and the FED becomes more aggressive. If we see early warning signs appear and our own TRI (Traphagen Recession Index) tick much higher, signaling a possible recession, we will take action.

We wish you and your family a healthy, happy, and prosperous 2018. As always, remember that your Traphagen advisors are monitoring your portfolios and are confident **they are positioned for both asset protection and good long term returns**. Attached you will find an addendum highlighting our thoughts on specific market sectors for Q4 2017. **We continue to appreciate the continued confidence and trust you have placed with us.**

Best regards,

Your Traphagen Investment Team

Addendum (Q4 2017 Asset Class Summaries)

Equity Market Update (Q4 2017)

The 4th quarter was excellent for US and global stocks with the SP500 returning 6.6%. This large increase was due to a combination of continued strong US and global growth along with the passage of the largest tax reform bill since the 1980s. Foreign stocks, although outperforming on the year, trailed slightly in Q4, but still returned between 3.5% and 6.0%.

Energy, technology, and financials were the top sector performers in the quarter due to perceived advantages from tax reform and recent 'bargain hunting'. Returns for these sectors ranged from 7% **-** 9%. Utilities were the worst, down 1.5%

Fixed Income Market Update (Q4 2017)

The bond markets had a very quiet quarter with mixed performance results. High yield and Treasury bonds were down less than 1%, while emerging market bonds and investment grade returned around 1%. The 10 year Treasury note yield rose slightly through the quarter from 2.36% to 2.44% at the end of the year. Again, over the course of 2017 rates were little changed.

Real Estate / Commodity Market Update (Q4 2017)

The real estate market had a good quarter, rising 2.7%, although so far in 2018, the asset class has given this up and then some with higher interest rates. Currently the real estate index yields around 4%, which is in line with recent years. Commodities had a great quarter, largely propelled by tax reform, global growth, increases in demand, and some bargain hunting. Pipelines were flat for the quarter, but with the increase in volumes and demand for oil/natural gas, this sector is already up 3.6% in 2018.

Alternative Market Update (Q4 2017)

The Insurance linked asset class had a slightly negative quarter after a poor year. Both funds were down between 1% and 2% in the period with some residual hurricane impacts and the California wildfires. Managed futures had a good quarter and ended the year marginally positive, with LFMAX returning 2.7%.

The 'All asset variance risk premium' fund (AVRPX) which continually sells options on many different asset classes performed very well. The strategy was up 11% during 2017 with a near flat Q4. Finally, LENDX & RMPLX our alternative lending funds, had a virtually volatility-free year, while returning 6% on the year and 1.5% in the quarter. Unlike other debt instruments, rising interest rates has little or no impact on the fund.