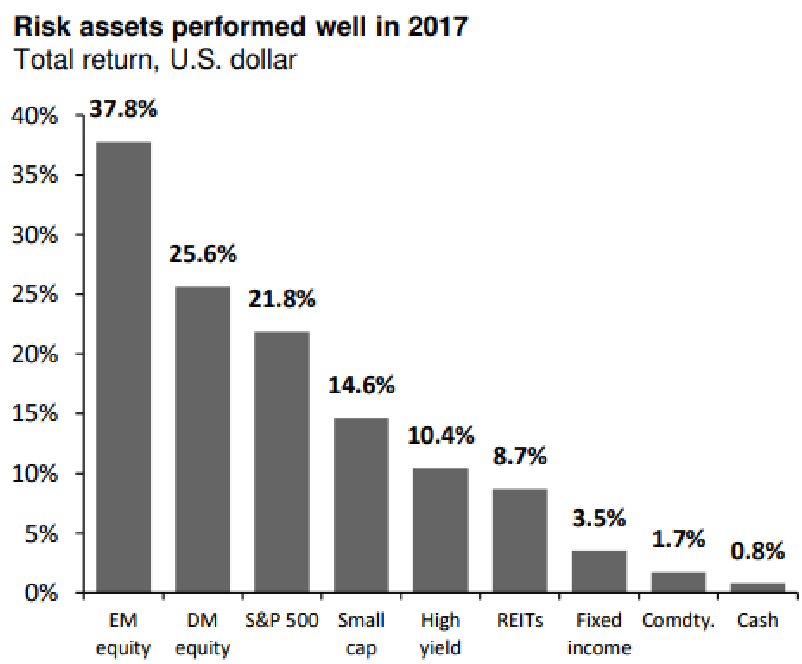
CWM Year-end 2017 Investment Commentary

Buoyed by strong corporate earnings and an ever-improving global growth picture, most major equity markets enjoyed robust returns during 2017 amidst a low volatility backdrop. The S&P 500 index recorded its first ever "perfect year" in 2017 with every month's results being positive; that has never happened before. The S&P 500 index set more than 70 new highs during the year and finished 2017 up more than +20% as growth strategies beat value and large cap stocks outperformed small. Global markets performed equally as well as business activity continues to improve. Such growth has translated into better-than-expected corporate earnings for foreign companies. Major developed international equity markets were up +20% in USD terms and emerging markets posted +30% returns, their best annual performance in more than five years. As the graph below notes, stocks handily beat bonds in 2017 and the cash rate remains anchored near zero.



Source: Barclays, Factset

The themes that we have been evaluating and consistently discussing over the course of the past sixteen months are being recognized by the market, namely that an improving global growth picture, better-than-expected corporate earnings, low interest rates, and an overall absence of inflation is leading to expanding market multiples and an enhanced level of risk appetite. The surprise of 2017 wasn't that risk did well; the surprise of 2017 was that volatility was completely nonexistent. The U.S. stock market only retreated by 3% three different times during last year, the least volatile year in terms of drawdowns since 1995. Certainly such a low volatility experience will not continue to exist. The stock market routinely contracts 10% in any given year, as it has eight other times since the Great Recession. When volatility does eventually surface it will feel unusually high because we haven't had any in a long while. But a look at history shows that -10% drops in the context of a longer bull market are completely "normal." We believe investors should expect and prepare themselves for a more "normal" level of volatility in 2018 and beyond.

As we start the new year, the two questions I am asked most often in client meetings and presentations are: "how long can this bull market last?" and "what are you most worried about?"

Since 1926, the stock market has experienced 11 bull markets that have lasted in duration an average of 54 months. The shortest was the bull market of 1960/1961 which lasted only 13 months and returned just +39%. The longest bull market in the past hundred years was the bull market which commenced in October 1990; it lasted 113 months and returned more than +400% along the way. We are currently in month 105 of this bull market and even the first few days of good returns in 2018 has many investors thinking about how long the good times can last.

Bull markets are like baseball games: time doesn't matter. Both are over when all the outs have been recorded. <u>Bull markets don't end because of time</u>. <u>Bull markets end because weakening fundamentals are ignored and, more importantly, too much bad credit is being created</u>. Bull markets end when investment strategists start mentioning that "this time it's different" or that "we have entered a new paradigm". Bull markets end when ISM manufacturing data is retreating below 50; today the U.S. ISM reading is a healthy 56. Bull markets end when inflation has taken hold and corporate earnings are getting squeezed; inflation is AWOL at present and corporate earnings should grow double digits for each of the next two years. Bull markets end when flows into stocks greatly outpace those into fixed income. Bull markets end when the credit markets are shutting down and liquidity is becoming scarce; today, credit spreads are stable and global central banks are sitting on more than $15 trillion in liquidity. And lastly, bull markets end when short rates are higher than long rates and bad credit is created against the backdrop of an inverted yield curve. The yield curve today is as flat as any other time since the Great Recession. At approximately +50bps between 2 year and 10 year Treasuries, the yield curve is "flatter" but certainly not "flat" or "inverted". That distinction is subtle but also very significant.

The old Wall Street line regarding bull markets will continue to hold true, namely that "bull markets are conceived in fear, born in despair, grow in skepticism, and die in euphoria." The data we evaluate today signals that we're still in the "skepticism" phase but still well short of "euphoria." This bull market, like its predecessors, will end when the data signals a change in economic momentum and the yield curve inverts. Until then, risk will continue to be rewarded.

And, as for what I am most worried about, it's not North Korea, cyber attacks or late night tweeting by members of the Executive Branch. Those are all well-documented risks but there's very little any of us can do to predict their timing or prevent them from occurring. What I am most worried about is an unexpected and poorly communicated change in global central bank monetary policy. The Fed has already embarked on its program of raising rates and shrinking its balance sheet but it would be a surprise change in direction by the ECB that would catch the markets off guard. At present ECB policy is very accommodative, Eurozone rates are anchored near zero and no major policy change is anticipated until the latter half of 2019 at the earliest. An abrupt or poorly-timed change to any of these strategies would be difficult for the market to digest. I think any changes to ECB monetary policy is the biggest risk for the market over the next two years.

2018 will hold new challenges and new opportunities for us all. The entire team here at CWM greatly appreciates our clients' trust and confidence and we will continue to work hard every day to earn both.

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