

BCA 2017 Review and Outlook

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Summary Outlook

- Speaking tactically, it's not yet time to reduce equity exposure. Earnings growth, still-easy financial conditions, and modest inflation mean it's likely stocks continue to climb – for now. Valuation is high, but multiples tend to stay high or even rise in the later stages of a bull market. However, the old Wall Street proverb still applies: if the market is keeping you up at night, “sell to the sleeping point.”
- It's an unchallenging call to say brace for rising volatility, because the recent smooth period was practically unprecedented. We think signs of complacency and excessive risk taking are becoming more prevalent, and expect to be downshifting equity exposure at some point this year. Still, we plan to be in tune with the market unless we see an environment change.
- A real but little-discussed risk is that the tax cuts heat up the economy too much, bringing a sharper Fed rate cycle than is anticipated. This could be disruptive to financial markets and could boost the odds of a recession in 2019. A move to exit NAFTA could make things worse.
- International markets are set for another strong year. Valuations have yet to catch up in Europe, Japan and Emerging Markets generally. Meanwhile, the same supportive conditions of non-inflationary growth and a more stable macro environment should help support equities.
- Bonds are not an attractive investment at current yields. Corporate bonds should outperform governments, but a tightening in financial conditions could put these at risk in the second half of 2018.
- Companies are increasing their capital expenditure spending, which should favor more cyclical (Value) stocks. Meanwhile, the valuation gap between growth and value is huge. For these reasons we like tactical positioning in energy and interest-rate sensitive financials.
- If realized, this scenario could be a positive for distressed debt strategies, which could benefit from dislocation. Large buyout strategies are getting quite crowded as fundraising efforts have been too successful, leading us to be cautious there.

2017 Review

Before writing this outlook, we looked back at predictions made this time last year. Stocks had rallied sharply following the election, leading most pundits to advise caution for the year ahead. The main concerns were a populist wave signaled by Brexit and the U.S. election, slow growth globally and the uncertainty about the end of Quantitative Easing. At the time, Wall Street consensus forecast just over a 5% return for all of 2017. As we know now, the S&P 500 blew through this by February, rising inexorably to a 21.8% return for the year.

We didn't predict a sharp equity rise either, but the point is to be wary of near-term predictions. At present, the environment is so positive, and the rise in stocks so bullish, that the Wall Street consensus has returned to its more typical 8%-ish prediction, with the caveat that risks are

elevated. But the environment can change, and investors can realize suddenly they've gotten ahead of themselves. In short, your allocation needs to be long term, and able to tolerate a significant pullback that can occur unexpectedly.

2017 brought some surprises. Except for financial companies, most "Trump Trade" beneficiaries underperformed despite deregulatory steps, hopes for an infrastructure package, and the enactment of a major tax bill. Oil rose sharply, but energy and MLPs stubbornly lost ground. Investors' move toward passive investing made records – yet correlations between stocks and sectors declined significantly, against expectations. Despite higher rates in the U.S., the dollar weakened, as growth proved surprisingly strong in other parts of the developed world.

Index	Total Return	
	Q4 2017	YTD 2017
S&P 500	6.6%	21.8%
Russell 1000 Growth	7.9%	30.2%
Russell 1000 Value	5.3%	13.7%
Russell Midcap	6.1%	18.5%
Russell Small Cap	3.3%	14.6%
MSCI EAFE (International)	4.3%	25.6%
MSCI Europe	2.3%	26.2%
MSCI Emerging Markets	7.5%	37.8%
Japan	8.5%	24.4%
US Aggregate Bond	0.4%	3.5%
High Yield Bonds	0.5%	7.5%
Crude Oil	21.6%	3.3%

Source: Factset Ned Davis Research

Note: International market returns reported in U.S. Dollars, not local

International stocks performed extremely well for the year. In addition to faster growth, Europe benefited from election results supportive of the Euro. France even elected a pro-business president! (whose election also was a rejection of nativism/populism). Commodities finally rose after a multi-year bear market, which helped Emerging Market stocks. Chinese technology companies and rebounds in major markets like Brazil and India were also important factors.

Turning back to the U.S., Growth style investing continued to dominate Value, as technology grew to a 23.8% weight in the S&P, below only the dot-com peak weight. The difference this time out is that earnings growth is strong, as well. Large-cap stocks again outperformed small caps. Investors continue to show a preference for companies with strong international revenues, which fits with the synchronized global growth theme. However, small cap companies are bigger tax cut beneficiaries because their taxation is more purely domestically-based. Overall, this continues to be a momentum-driven market of which large technologies companies are a considerable part.

In bonds, the broad Bloomberg Barclays Aggregate bond returned a moderate 3.5% for the year. High yield bonds rose 7.5%, reflecting risk-on trends in the market. Despite short term rates rising, long-term Treasury bonds rose 8.5% as the term premium (return demanded for inflation risk) fell further.

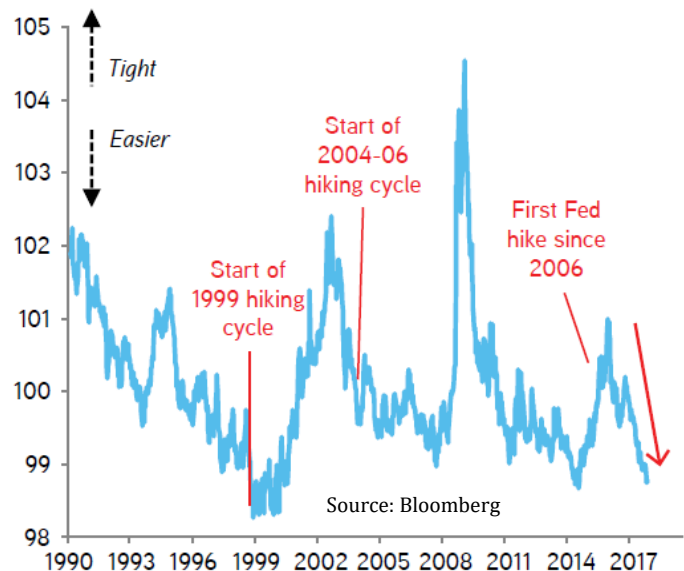
2018 Outlook

The past few years have demonstrated the perfect environment for markets was moderate economic growth, low inflation and easy money. This environment remains in effect as 2018

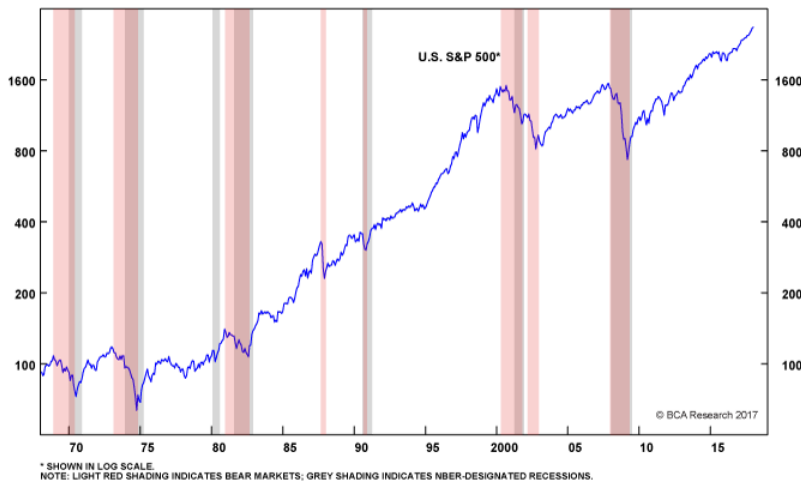
starts. Strong earnings revisions, M&A activity and buyback announcements could keep the market in overdrive. Companies will not immediately compete away the major tax windfall they have received, which could further boost profits. An important component of the bullish setup is that fact that, despite the Fed's 125 bps of rates hikes so far, financial conditions have *loosened* (see chart). This is unusual, and we don't think it can continue. Thus, while our outlook for the year is still positive, we expect problems to start showing up later in the year. Financial conditions, especially in the U.S., should gradually tighten as growth leads to building inflation pressures, encouraging central banks to withdraw stimulus. With U.S. equities highly valued and investor sentiment high, tighter conditions could pressure the market.

We can't help but feel 2018 has parallels to the late 1990s. The tech bubble ended disastrously and we are not saying we are at that point – while tech stocks have risen sharply, this time profits have grown rapidly as well. Yet signs of speculation abound as investors seem to be exhibiting more “FOMO” (fear of missing out), getting more bullish after the market has risen for years. Companies are renaming themselves to jump on the blockchain bandwagon, while speculators oblige management by rushing into their rechristened stocks. Investors are excited by the promise of disruptive technologies, and are disdainful of boring, cyclical companies.

GS Financial Conditions Index



Recessions and Bear Markets

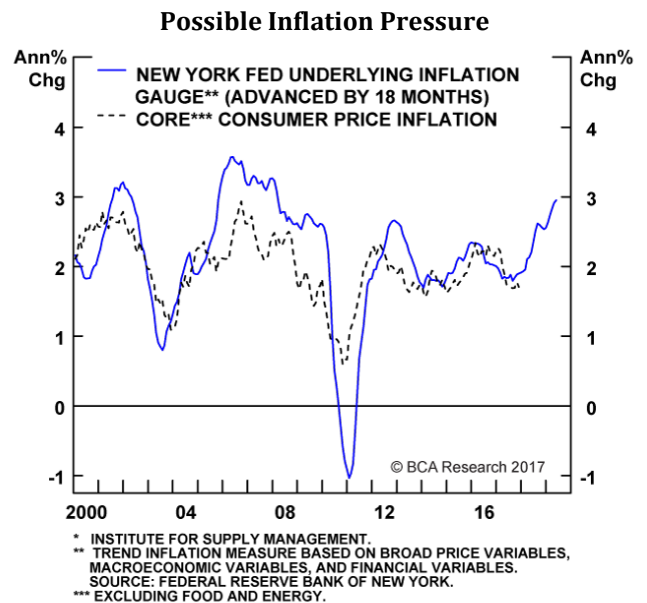


Even if financial assets are overvalued, the real global economy is doing well and is improving. Global surveys of economic activity continue to rise, and unemployment is still dropping. Many positive factors argue for very little chance of recession in 2018, including high interest coverage, tight high yield spreads, low delinquencies, and a modest consumer obligations ratio. This is very relevant to financial markets because significant market drops typically coincide with recession. Typically, stocks start to fall

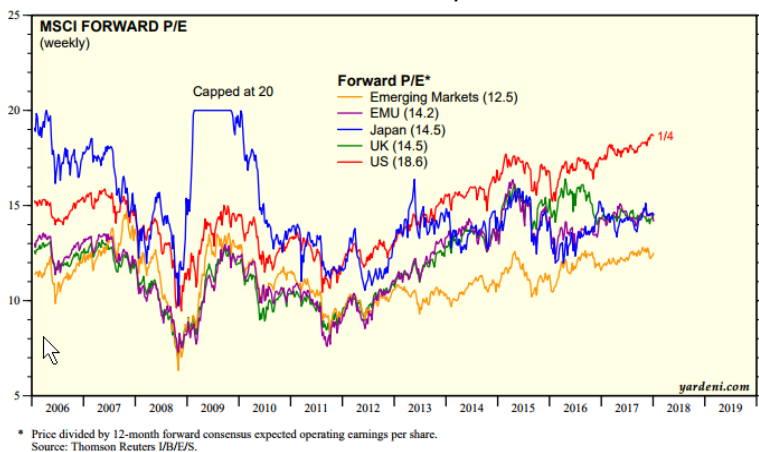
three to nine months before a recession. If we are right that recession is very unlikely in the next 18 months, it's an arrow in the bull's quiver for 2018.

Although we have been early/wrong to call for a bear bond market, we are sticking by it. The value in government bonds is just not there, especially for longer-term bonds. As the Fed continues to raise rates, the short end of the yield curve is looking relatively more attractive as a defensive option. We aren't excited by high yield bonds, either, because of very tight spreads. Still, the strong economic backdrop will likely preclude a major problem there. We think levered loans, which should trade at a premium to high yield corporate bonds but are instead trading at a discount, are a better choice.

But the biggest issue with bonds is what will happen with inflation. The market believes there will be a short-lived increase in inflation due to ongoing growth and the U.S. tax cut, but then expects economic weakness to return. Accordingly, the term premium has collapsed in intermediate and longer-term bonds. We think inflationary pressures are slowly starting to return (see chart). The wage inflation is still not showing up, but would be a real problem for safer bonds if it does.



Relative Forward P/E Ratios



We think international stocks will continue to outperform the U.S. Both the Euro area and Japanese stock markets are dominated by large multinational companies whose prospects are geared more towards global growth than domestic demand. Relatively high global growth and rising capital expenditure should disproportionately benefit these markets, given that they have a greater tilt towards cyclical companies. Despite 2017's rise, valuations still favor international stocks (see chart).

We are also positive on emerging market stocks. While valuation is now higher, there is still good news. Return on equity is improving, growth momentum is accelerating, and most EM currencies are now appreciating. Commodities are still important to Emerging Markets, and the 2011 to 2016 bear market was painful for many EM countries. However, technology and consumer companies are a much bigger portion of the index weight in EM indexes now, which also supports higher valuations. It's worth repeating that EM countries generally have much stronger fiscal policies than in past years. Despite rising debt, China's control over its banking system reduces the risk of a crisis.



The current environment should be a better setup for active management and hedge funds. Pairwise correlations for the S&P 500, which measures how closely stocks in the index move relative to one another, have fallen to 23-year lows of 7.4%, which is down sharply from 52% two years ago. Stock movements are increasingly driven by company or sector-specific factors. Moreover, correlations across asset classes have also plummeted this year as stocks have become less correlated with interest rates, foreign currency and oil. Global central bank policies are moving different directions (the Federal Reserve has ended QE, while Bank of Japan and ECB stimulus continues), a major factor behind this shift.

Immediately following the Great Financial Crisis, the retreat of banks made many lending strategies very attractive. While this is still the case, greater selectivity is now warranted. Robust pricing in liquid credit markets represents resurgent competition to some forms of private lending, particularly direct lending strategies. There has also been a lot of capital raised in the marketplace, particularly in the small deal size universe. There has also been less supply from M&A recently. So, that's the bad news. On the other hand, good opportunities remain, for example in areas where risk retention rules have helped hold back capital. In general, we will be focusing our private investing efforts where we can identify good underlying assets versus a pure cash flow approach.

Thank you for trusting Berman Capital to serve as your advisor. If you have any questions, please do not hesitate to contact us. We wish you a safe and happy New Year!

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