Main Street Advisors, LLC

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Market Commentary – Fourth Quarter 2017

Year-End 2017 *Key Takeaways*

The fourth quarter capped yet another stellar year for U.S. stocks. Larger-cap U.S. stocks gained 6.6% for the quarter and ended the year with a 21.7% total return. This was the ninth consecutive year of positive returns for the index—tying the historic 1990s bull market and capping a truly remarkable run from the depths of the 2008 financial crisis.

The broad driver of the market's rise for the year was rebounding corporate earnings growth, which was supported by solid economic data, synchronized global growth, still-quiescent inflation, and accommodative monetary policy. U.S. stocks got an additional catalyst in the fourth quarter with the passage of the Republican tax plan, presumably reflecting investors' optimism about its potential to further boost corporate after-tax profits, at least over the shorter term.

By year-end, the S&P 500 Index had rallied for more than 400 days without registering as little as a 3% decline. This is the longest such streak in 90 years of market history, according to Ned Davis Research.

Foreign stock returns were even stronger, with developed international markets gaining 26.4% and emerging markets up 31.5% for the year. In the fourth quarter, however, these markets couldn't match the S&P 500, gaining 4%–6%. Our portfolios benefited from meaningful exposure to emerging-market and European stocks, through Artisan International, Oakmark International, Harbor International, and T. Rowe Price New Asia.

Moving on to bonds, the core bond index fund gained 3.5% in 2017. This return was close to the index's yield at the start of the year, as intermediate-term interest rates changed little during the year. Although the Federal Reserve raised short-term rates three times, yields at the long end of the Treasury curve declined and the yield curve flattened.

Corporate bonds across all credit qualities and maturities had positive returns. High-yield bonds gained 7.5% and floating-rate loans rose 4.1% for the year. Investment-grade municipal bonds rebounded from a flat 2016, returning 4.5%. Of course, the primary reason for holding bonds is to provide protection during stock market declines. And our long-held tactical positions in several flexible and absolute-return-oriented bond funds added value, outperforming core bonds by several percentage points.

We continued to hold gold bullion (via the GLD exchange-traded fund) in many accounts last year, and it gained more than 12% for the year. While bitcoin and etherium grab the headlines, it is gold that is the world's oldest and safest store of value. It's price rises during times of uncertainty OR when the world's reserve currency weakens or is under duress. The U.S. dollar was weak last year and that only figures to continue with the just-passed tax law.

The year 2017 was a very good one for most financial markets. While the macro outlook remains positive, unprecedented central bank policy shifts could trigger increased volatility, a stock market correction, or even a recession sometime in this business cycle. During this uncertain time, it is all the more important to stay disciplined and patient. We remain confident in our diversified portfolio positioning looking ahead over our long-term investment horizon.

Looking Back: Key Drivers of Our 2017 Portfolio Performance

Our globally diversified balanced (stock/bond) portfolios generated stronger returns for the year, consistent with the positive overall return environment for most financial markets and asset classes. Our meaningful exposure to European and emerging-market stocks was a significant contributor, as foreign stocks outpaced U.S. stocks in 2017.

On the whole, our portfolios benefited from our larger-cap U.S. equity managers. We invest with concentrated, active managers across a range of investment approaches and "styles," including growth-oriented managers—and both of our dedicated U.S. growth managers soundly beat the growth index in 2017, especially Harbor Capital Appreciation. However, after a strong rebound in 2016, value stocks and many valuation-sensitive managers struggled to keep up with the surging market. We are confident our diversified active manager lineup remains strong and believe our value-oriented managers will be rewarded once this growth-oriented cycle turns, as it historically has.

Stocks were not the only contributors to our portfolio returns. Our tactical positioning toward flexible, absolute-return-oriented fixed-income funds resulted in several percentage points of outperformance versus the core bond index's 3.5% gain.

To the extent our returns missed out on even more growth last year, blame our defensive holdings of energy stocks and pipelines for that. We are not aggressive investors and so balance our adequate holding of technology stocks with "out of favor" stocks of essential companies as well. Interestingly, and although it's early, energy stocks and pipelines have surged in the first two weeks of the year.

Looking Ahead: Updates on Our Asset Class Views

U.S. Stocks: As noted above, U.S. stocks were up 21% for the year, driven in part by expectations of a historic corporate tax cut, which the Republican-led Congress duly delivered. We suspect much of the benefit of tax decreases might be priced in based on consensus earnings estimates for the S&P 500.

Foreign Stocks: Political uncertainties notwithstanding, Europe continues its economic recovery within what appears to be a benign fiscal and monetary environment. Europe is matching the United States in terms of economic growth and, according to Capital Economics, is on track to generate its strongest growth since 2007. Earnings have rebounded strongly, with Ned Davis Research analysis showing continental Europe and U.K. local-currency earnings growing over 25% and 35%, respectively, over the past 12 months. (The United States has seen earnings growth of 14% over the same period, according to NDR.) While earnings were up strongly, investor sentiment was relatively depressed (especially during the fourth quarter), leading valuation multiples to compress.

Like European stocks, emerging-market stocks posted strong earnings growth of nearly 20%. Yet after the recent run-up, we still expect emerging-market stocks to generate mid- to upper-single-digit annualized returns over the next five years in our base case scenario. While not attractive in absolute terms (given equities' downside risk), these returns are still better than what we expect from U.S. stocks.

Fixed-Income: Our return expectations for core bonds remain muted looking out over the next five years, in the range of 2.5% to

3.2% (from a current yield of 2.7%). Today, we're faced with taking on elevated levels of interest rate risk for low yield. The yield per unit of duration is near its all-time low. For context, a 50-basis-point yield increase in the Bloomberg Barclays U.S. Aggregate Bond Index would wipe out more than a year of income. This explains our meaningful positioning away from core bonds in favor of flexible credit strategies (Loomis Sayles Bond, Osterweis Strategic Income), which we believe will outperform core bonds in a period of flat or rising rates. That said, we still maintain core bond exposure in our balanced portfolios to serve as ballast in the event of a risk-off environment.

As noted above, high-yield bonds and floating-rate loans had solid absolute returns in 2017. Looking ahead, we continue to consider substituting floating-rate loans for high-yield bonds. We acknowledge that low global rates, accommodative monetary policies, and healthy overall fundamentals could keep bond spreads historically narrow, at least in the near term. However, we think that higher interest rates in general, but particularly short-term rates, will result in a headwind for high-yield bonds but will benefit loans, as their coupons are tied to short-term rates. One factor that caused loans to lag high-yield bonds in 2017 was the meaningful amount of loans being called by issuers to reprice/refinance them at a lower cost. We expect this repricing trend to abate and loan coupons to increase, narrowing the gap relative to bonds. However, we also see limited room for loan price appreciation. Our 2018 base case return estimate for floating-rate loans is in the range of 4.5%.

<u>Alternative Strategies:</u> It was an interesting year for trend-following managed futures funds, like our discarded Grant Park Managed Futures. The likelihood of a stock market "Trump jump" was high going into last year, whatever one's opinion of him. For several years we wrote of our having "one foot on the brake" with the accelerator; gold bullion, silver, and GPMF were those brakes. Now we don't have as much protection.

Amid all the uproar over crypto-currencies like bitcoin, we continue to have a strong interest in maintaining (or adding) gold bullion positions in most portfolios. We have used GLD for almost twelve years and returns for most of us are good over that time. A discussion on this is always welcomed, as gold clearly has desirable benefits if and when a strong market downturn occurs.

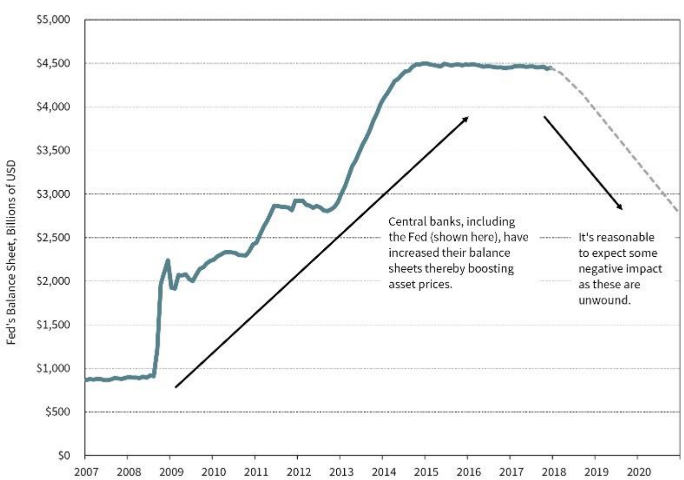
Arbitrage strategies (Merger Fund) generally experienced positive conditions last year. The merger-arbitrage universe experienced relatively few deal failures. Deal spreads have been fairly range bound most of the year, but they widened in the third quarter on fears of protectionism hampering cross-border transactions. Announced deal activity is below its peak level of two years ago but remains above the long-term average. With borrowing costs still low, but short rates significantly above zero, conditions are supportive for reasonable expected returns.

Looking Ahead: A Quick Word on the Macro Outlook

In terms of the near-term macro outlook, the consensus view is that there is little risk of a U.S. or global economic recession in 2018. The market expects the in-sync global growth that we saw in 2017 to continue. Most of the investors and strategists we respect seem to share this view. However, when an outlook becomes the strong consensus view, one should assume it is *already discounted* to a meaningful degree in current market prices. This is where our investment discipline comes in, because we think we have an edge in assessing fundamentals, valuations, expected returns, and risks *across different asset classes* and *over longer-term periods*.

We fully expect to get the opportunity to add back to our U.S. stock exposure at prices that imply (much) better expected returns across our scenarios. One obvious trigger for that would be a meaningful drop in the market. We believe a bear market is likely sometime in the next two to five years (our tactical time horizon). Again, we can't confidently predict exactly when, but one reasonable scenario would be triggered by ongoing monetary policy tightening, which is already underway in the United States, to be followed by other central banks. Given the boost to asset prices from unprecedented monetary stimulus, it is reasonable to expect some negative impact as central banks stop and then reverse course. On the other hand, should U.S. stocks continue their very strong upward trajectory, we will further reduce our exposure to them. There are a lot of variables involved, but all else equal, one key trigger for U.S. stocks would be if even under our optimistic/bullish scenario, we are seeing low-single-digit five-year expected annualized returns, down from 7%–8% currently.

Central Banks are Set to Unwind Their Unprecedented Policies



Source: Federal Reserve. Data as of 12/31/17. Unwinding projections based on stated Fed policy: $10 billion per month starting October 2017, rising $10 billion each quarter until $50 billion per month.

Putting it All Together: Our Portfolio Positioning

Currently, our base case scenario implies very low expected returns for U.S. stocks. As such, we remain defensively positioned in U.S. stocks and tilted toward European and emerging-market stocks, where our return expectations are materially higher. We were heartened to see our investment thesis of a European earnings rebound coming through strongly last year. However, we don't believe our portfolios have been fully rewarded for this yet given European stocks lagged the U.S. market in local-currency terms, so we're maintaining our tactical overweight to Europe. We also remain comfortable overweighting emerging-market stocks slightly relative to U.S. stocks, although valuations are less compelling than they were a year ago.

Our fixed-income positioning also remains unchanged. In light of the particularly low expected returns for core bonds, along with the risk of rising interest rates (which correspond to lower core bond *prices)*, we have meaningful exposure to flexible, actively managed bond funds. While our base case five-year expected returns for these funds are several percentage points above that of core bonds, they do carry more credit risk than core bonds. We factor this into our overall portfolio risk exposure, and it's why we still maintain a meaningful allocation to core bonds in our more conservative risk-sensitive portfolios. Despite their poor longer-term return outlook, we expect core bonds to perform well in a traditional bear market/recession.

Lastly, most of our portfolios have allocations to gold bullion or merger arbitrage funds. These strategies are "alternative" in that they have different drivers of return and risk than traditional stock and bond investments. We believe they have superior risk-adjusted return potential relative to the mix of stocks and bonds from which they are funded. While the "insurance" value of these investments hasn't been realized during the strong equity market run-up, we remain confident their relatively low correlation (or no correlation) to other investments in our portfolios is a valuable long-term benefit.

Concluding Comments

The year 2017 was a very good one for most financial markets and particularly global stocks. Yet we know the path to *long-term* investment success is simple to describe but not easy to achieve. Acknowledging this, we focus on the more realistic goal of having a high batting average—maintained by following our investment discipline and only taking on risk when we believe it raises the client's portfolio return potential without materially impacting the potential downside. We expect that it is "during the curves" and not down the straightaway that we will add the most value to our investor clients.

Thank you for your continued confidence and trust. We wish you and yours a very happy, healthy, peaceful, and prosperous New Year.

-Main Street Advisors, LLC (01/16/2018)