TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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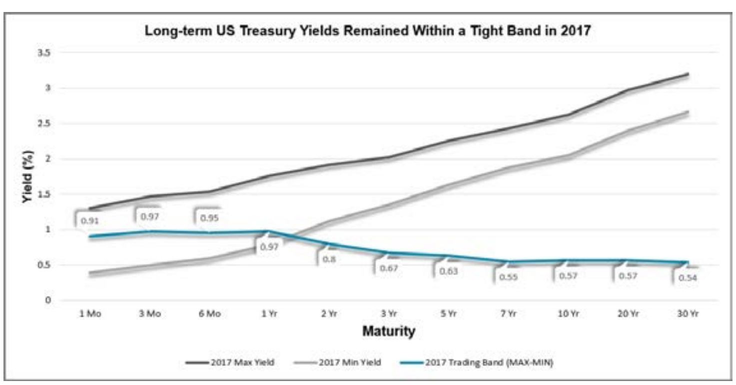
Stock Market Development

US equities had a great year, remarkable not only for their strong returns of 19.4% for the S&P 500, but also for their consistency and lack of volatility. They delivered positive returns in every single month of 2017, the first time this has happened since 1958. Strong corporate earnings, healthy economic growth, such as increasing capital goods orders, and the prospect of US tax cuts have supported the upward trend in equity markets, while synchronized global growth acceleration and declining unemployment rates played supporting roles. The rally in the US equity markets was relatively broad based, with tech stocks rising by close to 40%, and consumer discretionary, materials, industrials, healthcare and financials all returning about 20%. Defensive bond-proxy sectors, such as utilities, telecommunications and real estate investment trusts lagged over the year.

Fixed Income Market Development

One of the major themes of 2017 was low volatility. Longer-term Treasuries traded within very tight ranges in 2017; the difference between the 2017 high and low yields on the 10-year US Treasury was only 57 basis points, making 2017 the least volatile year in decades. Another major theme was the flattening of the yield curve. Driven by action from the Fed, which raised the federal funds target rate three times, we saw significant increases in short-term rates over the year. Conversely, long-term yields decreased. The yield on the 30-year US Treasury fell by 30 basis points during the year, while the yield on the one-year increased by 87 basis points. The movement in the yield curve had a significant impact on performance – short-term bonds were among some of the worst performers in 2017, while long-duration bonds were among some of the best. The Barclays Short Treasury TRA Index was up 0.8% and the Barclays US AGG TRA Index 3.5%.



The Economy

The markets have, to a large extent, already priced in economy boosting changes of the new tax code. It is impossible, however, to predict at this point the extent to which repatriated earnings will be used for dividend payouts and stock buy-backs versus increased capital investments and higher salaries for employees. With or without the tax stimulus, the economy is already on the cusp of a meaningful pickup for multiple reasons: First, continued tightening of the labor market will give workers greater bargaining power and ultimately lead to higher wages. Second, business investment should provide a larger boost to growth in response to rising capacity constraints and an improving corporate profits environment. Third, faster global growth will boost demand for U.S. exports. Fourth, the housing sector has been sluggish to engage in the current cycle and is likely to gain more traction. Fifth, benefits from deregulation. Furthermore, rising household incomes and cleared credit histories following the foreclosure crisis should support at least a modestly firmer contribution. While the economy has chugged along at a roughly 2% annual pace for most of the current cycle, it is on the cusp of a sustained acceleration -- toward at least 2.5% -- as consumer spending will finally be accompanied by a broader array of growth drivers.

Federal Reserve Policy

Inflation may be preceding at a lackluster pace, but the Fed seems to be moving at a quickening pace toward a less accommodative policy with regards to both interest rates and asset holdings. An exceptionally low unemployment rate and financial-stability concerns are among the primary motivating factors. Policy is likely to remain accommodative, but will become considerably less so if the Fed sticks to its current plans. The Fed is said to raise interest rates three times in 2018, but it is very likely in our opinion that they will hold off until mid-year until there is more certainty of an inflationary trend. Furthermore, the Fed does not want to send a wrong signal about the prospects for the U.S. economy by rising rates too swiftly (triggering an inversion of the yield curve).

TN-Outlook

U.S. stocks are expensive by virtually all measures. The cyclically adjusted price-earnings ratio of equities relative to 10 years of profits are more stretched than any time in a century with the exception of the dot-com era. A more appropriate methodology at this juncture of the market is price not just to earnings, but to earnings growth known as the PEG ratio, which is a technique favored by the famous investor, Peter Lynch. It takes the standard valuation and adds time -- time for a stock to grow into its price. The average PE of the S&P 500 index is 23. Analysts forecast a 15% increase in earnings in 2018, the fastest clip since 2011 and 13% a year through 2012 (Bloomberg). While the current 1.43 PEG ratio still exceeds the average of 1.24 since 1985, it is down from a record 1.72 in early 2016 and trails readings during four distinctive periods. Profit forecasts are rising. Upgrades will continue for the rest of the year as analysts wait for the benefit from December's tax cuts to kick in. Estimates have, so

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far, likely only been a fraction of the probable impact. Furthermore, under the new tax law, corporate cash and cash equivalents will be taxed at 15.5 percent, less liquid assets at 8 percent, payable over eight years. It can, therefore, be assumed that cash will be reinvested in less liquid assets which should bode well for stock prices. Financials, Energy, Materials, Consumer Discretionary, Industrials and Technology are all interesting sectors in 2018. We favor mid-cap stocks with a strong domestic presence, over large-cap, and growth over value.

For the first time in this bull market, investors can stay in short term investments without giving up meaningful income. Yields on two-year Treasury notes are up from 1.2% last year and nearly reached 2 percent, exceeding dividends in the S&P 500 Index by the most since 2008. With the Federal Reserve predicted to raise interest rates three times this year, the short end of the curve is likely to climb even higher. Markets are at or near the peak of the current cycle, and investors should become more defensive. We are expecting a slight steepening of the U.S. yield curve. The Fed's shrinking of its balance sheet, greater government deficits and less monetary stimulus abroad, mean investors will demand a higher premium on longer-term debt. In addition to short-term treasuries, convertible bonds, investment-grade fixed/floating rate bonds, short-duration corporates in the BB (below investment grade space) on positive watch for potential investment-grade upgrades, FRNs, inflation protected securities (TIPs), are some of the relatively attractive investment opportunities in 2018. We expect the fixed-income market to yield coupon income with price appreciation being uncertain "icing on the cake."

"Headwinds - longer term!"
The $ 1.5 trillion tax cut comes at a time where the economy does not need additional stimulus. It is not balance-neutral and will increase the U.S. debt which is estimated to reach the level of GDP in the next 10 years. In addition to the $ 1.5 trillion there are $ 300 to 400 billion in interest expense based on current low interest rates. Furthermore aging baby boomers will join retirement age in 2022 which is likely to put pressure on Social Security outlays. This is all in the future and may or may not happen but we need to be aware of these issues and keep a close eye on the markets which are known to be an early indicator of economic developments.

Happy investing!

Your dedicated Terra Nova Team!

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