



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2017

Leigh Bivings, Ph.D., CFP®



Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420



Executive Summary

- **Q4 2017:** Q4 was another strong quarter for global equity markets, with the overall global equity benchmark increasing 5.7%. Almost all regional markets posted positive returns, and emerging market stocks continued as the strongest performers, increasing by 6.7%.
- The U.S. equity market made a particularly strong advance during the quarter, increasing by 6.6%. The market was buoyed by expectations for the new tax package and generally positive economic data.
- Other sectors. As for fixed income, credit markets outperformed government bonds once again. Finally, for the first time in a good while, commodity returns were robust increasing at 4.7%. International real estate returns were also robust increasing 6.8% over the quarter.
- **2017 Summary:** It was a stellar year for global equities with the overall global equity benchmark up by an astonishing 24.0%. The markets were underpinned by a near-perfect backdrop of steady, synchronized global growth, low inflation, and continued accommodative policies. The biggest winner was emerging markets, which had their strongest year since 2009, increasing by 31%.
- **2018 Outlook.** Current economic indicators, combined with fiscal stimulus in the U.S. and accommodative monetary policy globally, suggest we are likely in for another good year in the markets. We are also likely, however, to experience more volatility than in 2017, a year of record-low volatility.
- **Artemis Strategy:** 2017 was a solid year for Artemis portfolios. We increased our overweight to equity relative to benchmarks, which was the main positive contributor to performance. We also maintained our strong overweight position to credit and added emerging market debt, which helped to boost all client returns. At the same time, our structural overweights to smaller companies and value versus growth companies disappointed. Finally, non-U.S.-based equities outperformed U.S. equities and our portfolios have a modest home-market bias relative to our benchmark.
- For 2018, we are planning to further adjust our equity tilts towards international and additional inflation protection. We are also initiating some thematic investing.

4th Quarter in Review

Q4 was another strong quarter for global equity markets, with the overall global equity benchmark increasing 5.7%. Almost all regional markets posted positive returns, and emerging market stocks continued as the strongest performers, increasing by 6.7%.

The U.S. equity market made a strong advance during the quarter, increasing by 6.6%. The market was buoyed by the passing of a new tax package. Though it will add a minimum of \$1.5 trillion to the deficit over the next ten years, indications are that it will be beneficial for company profits at least in the short term (and maybe longer). U.S. equities were also supported by generally positive macroeconomic data, including better-than-expected third-quarter GDP growth of 3.0% (annualized). Larger companies, led by the technology giants, outperformed smaller ones as has been the pattern throughout 2017. See Figure 1 for the breakdown.

Figure 1. 2017 Asset Class Returns in USD (%)

Asset Class	2017		Index
	Q4	Total Year	
Equities			
All Markets - Global*	5.7	24.0	MSCI ACWI IMI (net)
U.S. Large Companies	6.6	21.8	S&P 500
U.S. Small Companies	3.3	14.7	Russell 2000
Int'l Developed Markets	4.2	24.2	MSCI EAFE & Canada (net)
Emerging Markets	6.7	31.1	FTSE EM All Cap China A Inclusion (net)
Fixed Income			
All Segments - U.S.*	0.4	3.5	Barclay's U.S. Aggregate
U.S. Treasuries	(0.3)	2.5	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds	0.2	4.3	Barclay's Municipal Bonds, 1-15 Years
U.S. Corporate	0.2	5.2	Merrill Lynch U.S. Corporate Bond, 5-7 Years
U.S. High Yield	0.4	7.5	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	1.4	8.9	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds	1.2	10.5	J.P. Morgan USD Emerging Market Bonds
Real Assets			
U.S. Tips	1.3	3.0	Barclays Capital U.S. TIPS
Commodities	4.7	1.7	iPath Bloomberg Commodity
U.S. Real Estate Income	1.1	8.3	Fidelity Series Real Estate Income Composite
Int'l Real Estate	6.8	16.5	Dow Jones Global Ex-US Select RESI

*Used to create Artemis portfolio benchmarks



International developed markets slowed a bit in Q4. Profit-taking in Europe and a stronger euro were in part to blame for the slowdown, as the data showed the eurozone's economy recovery continuing. Indeed, the eurozone unemployment rate dropped to 8.8%, the lowest rate since January of 2009, with manufacturing activity at multi-year highs. In contrast, Asian equity markets, and Japan in particular, had a terrific quarter, with its equity market recording a record rise of 8.7%.

As for fixed income, U.S. Treasury yields rose over the quarter and the yield curve flattened, amid growing momentum behind the tax reform bill. For the quarter overall, the 10-year yield increased from 2.33% to 2.41%. Credit markets outperformed once again, with high-yield and corporate bonds outperforming Treasuries. Finally, for the first time in a good while, commodity returns were robust; they increased at 4.7%, led by a rally in industrial metals and energy. International real estate returns were also robust increasing 6.8% over the quarter.

Year in Review

The markets in 2017 were underpinned by a near-perfect backdrop of steady, synchronized global growth, low inflation, and continued accommodative interest rate policies (a so-called "goldilocks" environment). Global assets experienced remarkably low levels of volatility, with the S&P 500 not experiencing a single month in 2017 with a negative return. Even so, non-U.S.-based equities outperformed U.S. equities for the first time in five years, bolstered by a weaker dollar and a strengthened global economic backdrop. In the end, the overall global equity benchmark finished up by 24.0% for the year. See Figure 1.

While developed markets lagged slightly, emerging markets were huge winners. Emerging markets had their strongest year since 2009, increasing by 31%.

In the U.S., growth stocks also had a stellar run and outperformed value stocks during all four quarters of the year, ending 2017 with returns of 30.2% versus 13.7%. Indeed, all major equity categories and sectors ended the year with double-digit gains, except for energy and telecom stocks.

Overall returns in fixed income were much more muted, but all bond categories and sectors posted positive returns for the year. The Barclay's U.S Aggregate Bond Index gained 3.5% over the year, not bad considering the Fed increased short-term interest rates three times during the year. The big surprise of the year was the lack of inflation, even in the face of a very tight labor market and reasonable global growth. As a result, bond yields did not rise as expected, with the benchmark 10-year Treasury note ending 2017 at a 2.4% yield, or five



basis points lower than where it started. This was not the result the market had anticipated at the beginning of the year.

2018 Economic Outlook

The consensus narrative heading into 2017 was one of modest expectations. Interest rates were low and expected to increase, suggesting meager bond returns. Equity valuations were high, and the cycle was perceived to be getting long in the tooth, indicating the equity returns could be muted with increased risk of downside. In addition to the fundamentals, there appeared to be a high level of geopolitical uncertainty heading into the year.

If 2017 taught us anything, the difficulty in predicting short-term market direction should be near the top of the list. But even still, as a professional investment manager, I am compelled to develop a point of view – a lens from which to decide when and whether to alter the risk profile of client portfolios.

I must confess that it is tough to be pessimistic about the outlook when the whole world seems to be firing on all cylinders. I have never seen so many economic indicators pointing in the same positive direction at the same time. Just to name a few, global Purchase Managers Indices (PMIs) are above 50 and rising in all but a very few countries; Citi's Economic Surprise Index looks incredibly strong in the U.S. and is at a historically high level globally; and the European Central Bank (ECB) just recently raised its growth forecasts for the region for 2018 and 2019.¹ The list goes on.

Here are even more additional reasons to believe that growth is going to be particularly strong in the U.S. in 2018:

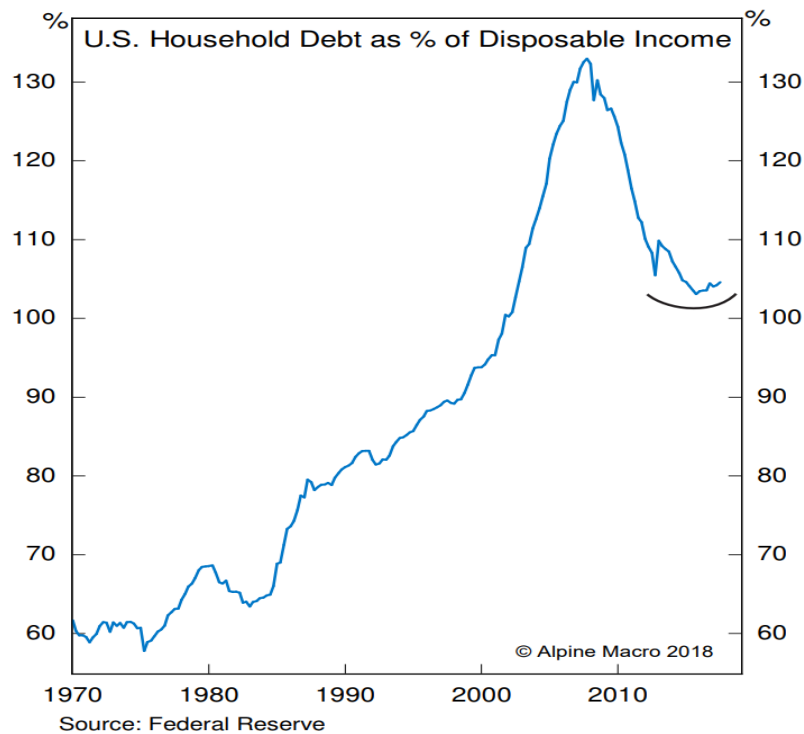
1. **Fiscal Stimulus.** While many would argue that we do not need to stimulate an economy that is effectively at full employment, the recently passed tax reform is projected to add \$137 billion to the U.S. federal deficit just over the next nine months. That is basically a federal stimulus that equates to 0.7% of GDP, making it likely that U.S. real GDP growth in the first half of the year will top 3.0%.

¹ The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The Citi Economic Surprise Index measures data surprises relative to market expectations. The surprise element is defined as the percentage difference between analysts forecasts and the published value of a large number of economic data.



- 2. Repatriation of Overseas Cash.** The same tax reform law provides companies a one-time opportunity to repatriate dollars earned abroad at a lower tax rate, and many companies are expected to take advantage of the opportunity. The current debate is whether companies are going to use the money for capital spending or simply to buy back shares and/or pay higher dividends to shareholders. While I'd prefer to see more capex spending to help shore up productivity, I'm of the view that companies are going to do more share purchases. The basic reason is that companies have had plenty of access to cheap credit for capex spending in recent years and so would have already boosted capital spending had they wanted to. In short, they don't need to repatriate foreign-earned profits for this purpose. Either outcome, however, is pretty good for equities.
- 3. Consumer Behavior.** Consumers have been deleveraging since the recession, in part because banks tightened up on home equity lines following the financial crisis, and in part because many folks simply lost their jobs. That process appears to be over, as shown in Figure 2. This means that consumer spending could grow at the same rate as – or even faster than – the natural rate of income growth. Given that consumer spending is two-thirds of total U.S. GDP, this is significant.

Figure 2. U.S. Deleveraging is Over





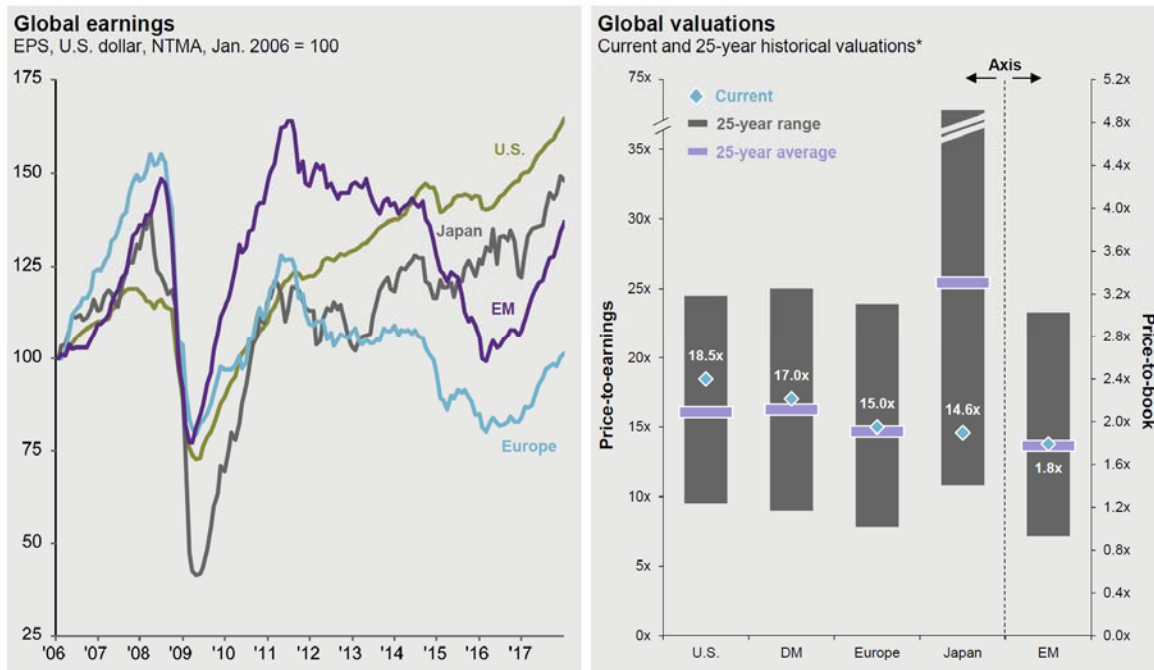
4. **Increased Capex Spending.** While I just argued that repatriated profits may not spur increased capital spending, corporate tax specialists are arguing that several other provisions in the new tax law might do so. These provisions include replacing capital depreciation allowances with 100% expensing and shortening the recovery period by 36% for business structures, such as office buildings. The argument is that these new rules will spur firms to front-load capital expenditures in 2018. We'll see.
5. **Continued Regulatory Reform.** Having won on taxes, word is out that the Trump Administration is going to push hard in 2018 to lessen the regulatory burden on companies. In recent history, financial deregulation, in particular, has been among the key catalysts behind economic and financial market booms (and busts).

2018 Investment Outlook

The key issue facing investors at the moment is whether most of the positive news is already priced into the market. If so, then it is vulnerable to a reasonable correction, which could occur at any time and without warning. I am not too concerned about the downside, as I really do believe we are in a structural bull market and so such a correction would be a good reason to buy more equity, not to run for the hills (and I would never advocate running in any case). Why? Several models I look at are estimating earnings growth of the U.S. corporate sector of about 15% over the next six months. And this is not even counting the potential impact of the recently-enacted tax reform package. Moreover, there is little evidence yet that inflation is going to rear its ugly head in a big way soon and almost no evidence that interest rates are going to take off. Added up, this means we may have another “goldilocks” year ahead of us, i.e. one of solid global growth and low inflation. And let’s remember, most of the global equity returns in 2017 were driven by earnings growth rather than multiple expansion (i.e., a willingness to pay more for an unchanged projected earnings stream), which makes the current rally more sustainable in my view. See Figure 3 (next page).

In short (and this is exactly what I wrote in last year’s outlook report), assuming President Trump doesn’t take us into a destructive trade or nuclear war, China doesn’t implode from credit excess, and President Trump gets more of his pro-growth policies (e.g., more infrastructure spending and regulatory reform) through Congress, stocks should outpace bonds again this year and do reasonably well. The key risk to this view, however, is that we get too much of a good thing and inflation accelerates beyond expectations. In such a scenario, central banks, including the Fed, may feel compelled to accelerate interest rate normalization, leading to a sharp bond sell-off and pressure on equities. I will be watching inflation expectations closely in 2018.

Figure 3. Global Equity Earnings and Valuations



Source: JP Morgan

Artemis Portfolio Strategy

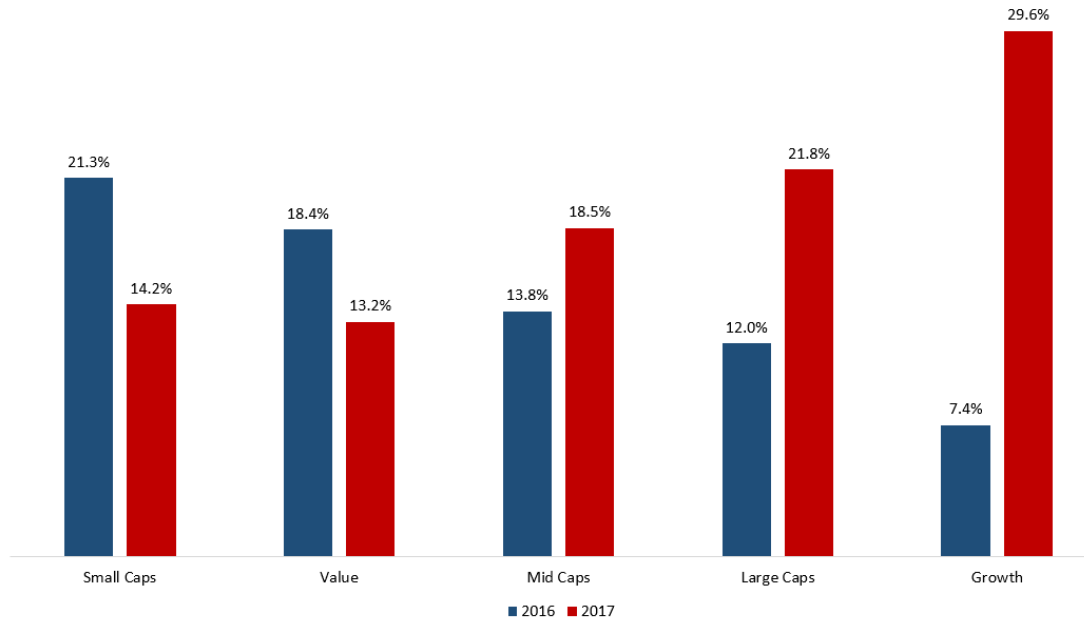
2017 Retrospective

2017 was a solid year for Artemis portfolios. Our biggest success was keeping everyone fully invested in the market. In addition, we remained, and in some cases increased, our overweight to equity relative to benchmarks. We also strengthened our overweight to emerging market equity, which was the highest-performing asset class over the year. And we maintained our strong overweight position to credit and re-established a position in emerging market debt, both of which helped to boost all client returns.

At the same time, our structural overweights to smaller companies and value versus growth companies disappointed in 2017. Growth and large companies strongly outperformed value and smaller companies in 2017, the exact opposite of what happened in the prior year. See

Figure 4. Finally, non-U.S.-based equities outperformed U.S. equities, and our portfolios have a modest home-market bias relative to our benchmark.

Figure 4. 2016 U.S. Equity Market Returns by Segment – 2016 versus 2017



Source: Fidelity

2018 Positioning

The big question on most managers' minds currently is whether to add more international equity to the mix at the expense of the U.S. At least that's the key question I am grappling with. I do feel strongly that most client portfolios are already maximum overweight to equity, given risk tolerance and other considerations, so it's really one of optimizing the mix.

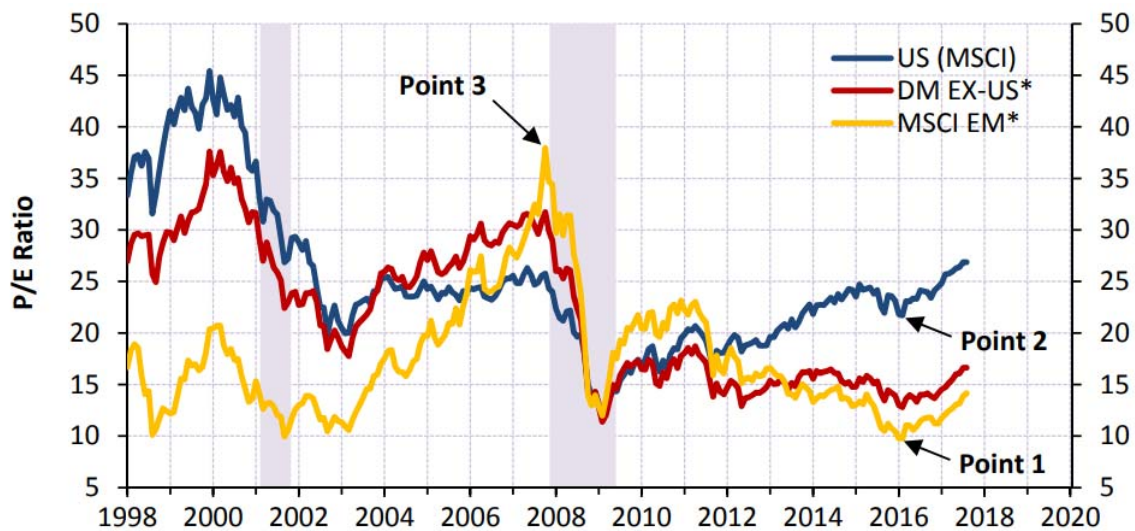
One of my favorite market experts is Jeremy Grantham, who in his recently-published quarterly letter, makes a strong case for international and emerging market equities especially over the next seven years (his firm's investment horizon) on a valuation basis.²

² Grantham, Jeremy. "Career Risk and Stalin's Pension Fund: Investing in a World of Overpriced Assets (With a Single Reasonably-Priced Asset)"; GMO Quarterly Letter, 3Q 2017.



His argument goes like this: 1. The current P/E of developed markets, ex-U.S. is well below its 20-year average and 40% below the U.S.; and 2) Emerging markets are 65% below their high in 2007 (although he makes the point that the 2007 P/E ratio for emerging markets was an overshoot if there ever was one). See figure 5.

Figure 5. Global Cyclically-Adjusted Price-to Earnings Ratios (CAPE) – 1998-2017 (as of 8/31/2017)



Source: GMO

Mr. Grantham also rolls out one of what he calls his all-time favorite charts (shown on the next page). This chart shows the relative moves over the last 45 years between the S&P 500 and the rest of the developed world ex-Japan and clearly shows that market leadership has oscillated between the two regions steadily over the period with each swing lasting anywhere from five to ten years. The chart also hints that we may well be at a key inflection point.

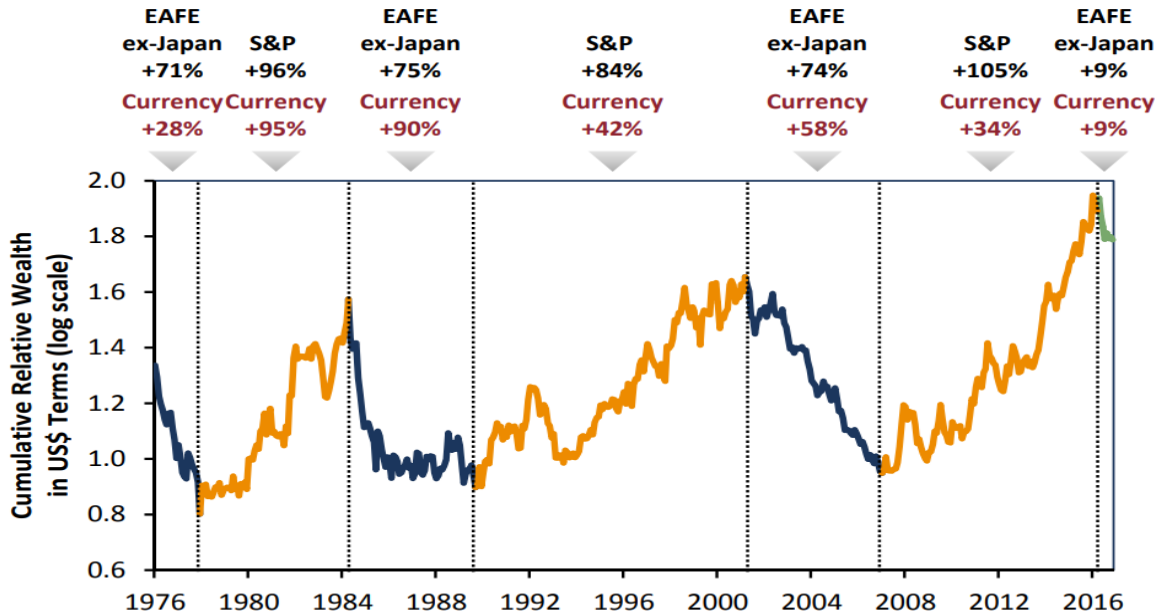
I tend to agree that these data are compelling, that current P/E ratios do matter in terms of medium-term returns, and so we are currently looking at potentially rotating further away from U.S. equity into these segments in 2018. I'm not in a super-rush however, given the short-term stimulus the Trump Administration just gave the U.S. economy.

I also plan to add a little more inflation-protection vis-à-vis buying Treasury inflation-protected bonds (TIPS), using a short-duration fund. I initiated this position in most client portfolios over the last year or so, and this was, in hindsight, early (or wrong). But with the



new tax law and an economy running out of workers, buying additional protection against unexpected inflation seems an ever more-reasonable bet to make this year.

Figure 6. U.S. versus Europe, Asia and Far East ex-Japan (EAFE) – Relative Performance



As of 9/30/17
Source: GMO, Standard & Poor's, MSCI

Finally (and thanks to a new client who got me motivated), I have decided it's time to have a little fun and wager a modest sum in select client portfolios on a few long-term themes that have the potential to transform the way we work and live. One of those themes is robotics and artificial intelligence (AI). Perhaps I'll make this a topic of a future quarterly report but, in the meantime, I and our new client have recently invested in an index-based fund that provides investors access to rapidly evolving robotics, automation, and AI companies from around the world. We are currently adding to more portfolios now. By all means, let me know if you have a good idea or two and we'll chase it down.

Here's to a profitable 2018!

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of \$150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.



The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.