MARKET Insights

January 2018

“The Hand-Off”: 2018 Client Outlook and Positioning

2017 Review

The US stock market (S&P 500) delivered 12 consecutive positive months in 2017, the first time that has happened in history. International markets delivered their best results in years, with developed markets (MSCI EAFE) up **+25.6%** and emerging markets (MSCI EM) up **+37.8%**, respectively in dollar terms. Investment-grade bonds ended the year virtually flat: the investment grade Barclays Aggregate Bond index delivered a total return of just **+3.5%**, provided almost entirely by coupon interest. High-yield bonds delivered better results as investors sought riskier debt during the year. The Barclays US High Yield Corporate index gained **+7.5%**. US government debt returns were even worse for foreign investors. Due to US dollar weakness in 2017, ten-year Treasury notes actually returned **-3.6%** in yen and **-12.3%** in euros (per CBOE). We anticipate further weakness in long-term US government bonds as foreign investors (who account for over 40% of US Treasury holders) rebalance away from dollar-denominated debt.

	Q1	Q2	Q3	Q4	Year 2017	Year 2016
US Large Stocks S&P 500	+6.1%	+3.1%	+4.5%	+6.6%	+21.8%	+12.0%
US Small Stocks Russell 2000	+2.5%	+2.5%	+5.7%	+3.3%	+14.6%	+21.3%
International Stocks MSCI EAFE (in US$)	+7.4%	+6.4%	+5.5%	+4.3%	+25.6%	+1.5%
Emerging Market Stocks MSCI EAFE (in US$)	+11.5%	+6.4%	+8.0%	+7.5%	+37.8%	+11.6%
Investment Grade Bonds Barclays Aggregate	+0.8%	+1.4%	+0.8%	+0.4%	+3.5%	+2.6%
High Yield Bonds Barclays US HY Corporate	+2.7%	+2.2%	+2.0%	+0.5%	+7.5%	+17.1%
Alternative Strategies HFRX Global Index	+1.7%	+0.9%	+1.8%	1.5%	+6.0%	+2.5%

Source: FactSet Indexes through December 31,2017

Final Report Card: How Our Clients Fared in 2017

We identified three themes for 2017, each of which performed in line with expectations for the year:
Theme 1: Maintain a pro-growth investment stance, favoring stocks over bonds
Theme 2: Shorten duration in bond portfolios, allocate away from government debt
Theme 3: Diversify global equities selectively, avoiding "anti-globalization" risk

Overall, Webster Private Bank portfolios benefited from these themes, and performance across the board was strong. Our discipline of focusing on high quality companies for individual stock portfolios and on well-established fund managers for mutual fund-oriented portfolios, allowed us to meet client objectives. This resulted in both favorable absolute returns and peer comparisons for our clients.

1 Maintain a pro-growth investment stance, favoring stocks over bonds

In 2017 stock markets seemed to shrug off any bad news and accelerated to new highs, especially in the latter half of the year. Theme 1 served our clients well, as stocks handily outperformed bonds. This was true across the board, as almost all stock industry groups and regions delivered double-digit results in 2017. Neither European populism, nor hurricanes, nor North Korean nuclear threats could derail the bull market. Investment grade and high yield bonds eked out modest, positive results. Their returns consisted almost entirely of coupon interest and not capital appreciation during the year.

2 Shorten duration in bond portfolios, look for other opportunities

The bond market was essentially flat in 2017. Our recommendation to underweight government bonds, especially those of longer maturities, in favor of other fixed income sectors worked well for clients. Yields on ten-year Treasury notes started and finished the year at **2.48%** and **2.43%**, respectively. The shape of the "yield curve" (plot of rates by maturity) flattened significantly in 2017, as rates on two-year Treasury notes rose from **1.26%** to **1.91%**.

Our clients profited from high returns on non-investment grade sectors, such as high-yield bonds, floating rate bank loans and emerging market US-dollar denominated debt. The additional yield (or "credit spread") offered by high-yield, non-investment grade debt fell from 4.09% to 3.43% during the year, as investors accumulated higher risk debt to offset shrinking yields from government bonds.

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3 Diversify global equities selectively, avoiding "anti-globalization" risk

In spite of the White House's anti-globalization rhetoric, we decided to broaden diversification in client Equity allocations, specifically in Europe and Emerging Asia. European Equities and emerging markets in Asia gained **+26.3%** and **+43.4%** in dollar terms for the year, according to MSCI. Nearly all major international markets outperformed US markets for the bulk of the year, with US stocks catching up in the fourth quarter in response to the tax reform legislation. Our "anti-globalization" theme led us to increase allocations to US small stocks, which are more domestically oriented. While this was a profitable decision, because small US stocks (Russell 2000) were up **+14.6%**, it lagged the **+21.8%** earned by large US stocks (S&P 500) for the year.

The Hand-Off: Key Themes for 2018

We believe 2018 will be characterized by a performance "hand-off" between asset classes, sectors and geographies. In fact, such a hand-off in asset class performance between stocks and bonds has been underway for at least a year. Global stocks have significantly outpaced bonds since the second half of 2016. We expect such divergences to accelerate in 2018, with differences between sectors, regions and strategies becoming more pronounced in the year ahead.

THEME 1: HAND-OFF FROM MONETARY TO FISCAL POLICY, INCREASING INTEREST RATES

Monetary tightening in the US has already begun. The Federal Reserve raised its target overnight interest rate three times in 2017—in March, June and December—from 0.75% to 1.50%. The central bank plans to continue with increases in 2018, likely bringing the target rate to 2.00%.

Meanwhile, Congress delivered its first major fiscal stimulus in almost nine years, with passage of the Tax Cuts and Jobs Act on December 22nd. It is estimated that the law could increase corporate profits by up to **+14%** in 2018 (according to Bank of America-Merrill Lynch). In addition, the economic stimulus from the tax cuts could add up to **+0.6%** to GDP in 2018 (per the nonpartisan Tax Policy Center). These actions combined with bond maturities running off the Federal Reserve's balance sheet are likely to reduce demand for US government debt and push interest rates higher. Labor markets are already growing tight. Broad "U-6" unemployment (which includes the headline unemployment number, plus part-time and marginal workers) stands at **8.1%**, its lowest level since March 2007. Higher minimum wages took effect as of Jan 1st in 18 states and 20 major cities. There is a real possibility for wage pressures to stoke consumer price inflation and, hence, interest rates. In addition, higher growth rates in Europe and Japan make local investments more attractive and further reduce demand for US dollars and Treasury debt by foreign buyers.

This is arguably the theme with the greatest potential to upset financial markets. If rate increases in the US are matched with monetary tightening in Europe and Japan, and there is a spark of higher inflation, it would ruin the Goldilocks scenario of high investment returns in a low inflationary environment that prevailed in 2017.

Portfolio strategy:

We recommend maintaining average maturities of less than five years in Fixed Income allocations, and emphasize short-term investment grade (including municipal bonds), floating-rate investments and inflation-indexed debt over high-yield bonds. In addition, we recommend increasing allocations to alternative strategies, such as convertible arbitrage and equity buy-write funds, in order to earn returns uncorrelated to the overall stock and bond markets.

THEME 2: MAINTAIN EQUITY RISK LEVELS, BUT HAND-OFF TO GREATER DIVERSIFICATION

Equity-oriented investors were rewarded handsomely in 2017. We expect stocks to offer higher returns than bonds, but the mix of stocks with the greatest potential has changed in our estimation. In spite of the potential for negative outcomes in Theme 1, we expect any decline in stock markets to be short-lived (i.e., less than one year), presenting an opportunity to reinvest at more attractive valuations and higher dividend yields, especially outside the US. Clients should expect greater volatility in stock prices than what we experienced over the last 12 months. During 2017, the worst decline for the US stock market (S&P 500) was limited to -3% (from March 1st to 27th), making 2017 the least volatile year in the post-WWII period. While it is possible that the current uptrend with low volatility continues for several months, we expect more volatile pricing for US large cap stocks in 2018. We are researching further opportunities in stock markets outside of US large cap companies and intend to shift client allocations away from US large cap holdings during the year.

Portfolio strategy:

Maintain overall Equity levels of investment, but begin a re-allocation of the mix of equity investments. Increase small and midcap US holdings, add to Emerging Markets in Asia, and add to European stocks. Consider adding more to absolute return strategies as a substitute for dividend paying stocks. Stand prepared to adjust positions in response to market volatility, either to the upside (for selling positions) or to the downside (for adding to positions).

THEME 3: EXPECT LOWER RETURNS AHEAD IN 2018

All major developed and emerging stock markets posted double-digit results in 2017 (even the Mexican Bolsa gained +10.5% for the year). These results followed a **+12.0%** return for US stocks (S&P 500) in 2016 as well. It is uncommon for stock markets to deliver double-digit results with low volatility for multiple years, so clients should prepare for headwinds in 2018. The new tax law may provide a temporary stimulus this year, but rising interest rates will affect the ability of less profitable companies to remain competitive. Any spillover from sour credit markets, even if confined to an industry such as retail or energy, may dampen investor appetite for stocks.

In the ten least volatile years since WWII, the US stock market (S&P 500) declined during the year by no more than **-6%**. 2017 now ranks as the least volatile year, along with 1995. The average market return across all ten years was **+25%**. In the following year, volatility increased sharply, with the market experiencing an average decline of **-12%** and returning just **+5%** for the year. The worst results were in 1961 and 1972, when the market fell **-26%** and **-23%** during the year and finished the year down **-12%** and **-17%**, respectively.

S&P 500 Index Return During and After "Low Volatility" Years (Post WWII)

Calendar Year	Correction During Year	Total Return	Next Year Correction	Next Year Total Return
1954	-4%	+45%	-11%	+26%
1958	-4%	+38%	-9%	+8%
1961	-4%	+23%	-26%	-12%
1964	-4%	+13%	-10%	+9%
1972	-5%	+16%	-23%	-17%
1991	-6%	+26%	-6%	+4%
1993	-5%	+7%	-9%	-2%
1995	-3%	+34%	-8%	+20%
2013	-6%	+30%	-7%	+11%
2017	***-3%***	***+22%***	***TBD***	
Average	**-4%**	**+25%**	**-12%**	**+5%**
Best	-3%	+45%	-6%	+26%
Worst	-6%	+7%	-26%	-17%

Source: Strategas Reserach Partners; Webster Private Bank calculations.

Portfolio strategy:

Because corrections are normal even during bull markets, we expect more volatility from stocks in 2018. The US market is priced nearly for perfection. We intend to protect client capital by reducing exposure to potential outcomes from both greater volatility and higher interest rates: keep bond maturities short; use floating rate debt and inflation indexed bonds as an offset to inflation; rebalance client holdings away from US large stocks and toward US small companies, European shares and Asian emerging markets; and, make greater use of alternative absolute return strategies which may benefit from increased stock volatility and offer returns that are not directly correlated to stock and bond markets.

Portfolio Themes and Positioning

Asset Class	Sector or Geography	Recommended Positioning
Equities	US Large Cap	Hold at target, overweight financial, energy and health care.
	US Large Cap	Underweight utilities, telecom and other"low volatility" bond proxies.
	US Small Cap	Increasing allocation in light of higher EPS from greater US domestic growth.
	Intl Developed	Increasing allocation to Europe and Japan, as growth accelerates more than US.
	Emerging Markets	Slightly overweight, emphasizing EM Asia and non-commodity exporters.
Fixed Income	Government Debt	Shorten duration, avoiding long maturities (10+ years).
	Municipal Bonds	Recommended for taxable accounts with buy-and-hold income mandates.
	Bank Loans	Substitute traditional high yield bonds with floating-rate, senior secured loans.
	High-Yield	Reduce position sizing. Current relative yields are not compelling.
	Inflation-Indexed	Increasing allocation to protect against increasing inflation rates.
	Emerging Mkt Debt (US $)	Reduce as US dollar weakness persists, and relative yields are less attractive.
Alternatives	Absolute Return	Increasing allocations to arbitrage and buy-write strategies. Seeking funds with returns uncorrelated to traditional stock and bond markets.
	REITs	Underweight due to interest rate sensitivity.
	Commodities	Negative on oil and base metals, avoiding gold due to real interest rate sensitivity.

Conclusion: Putting it All Together

As we pass the baton from 2017 to 2018, we continue to position client portfolios for synchronized global economic recovery, but are curbing our desire to add more risk due to the increasing probability of more volatility in the year ahead.

Inflation, which has been relatively benign as of late, could be a negative shock for US policy makers, as the Federal Reserve ends its tightening campaign this year and Congress aims to pass more stimulative spending. We are hedging both inflation and its associated interest rate risk by buying shorter dated bonds and US inflation-indexed debt, and adding to alternative strategies with low levels of volatility and interest rate sensitivity.

In order to enhance returns and manage equity risk, we are diversifying the market capitalization and geographic exposures in our clients' equity portfolios. Stocks of US mid and small cap companies, as well as those in Europe and Emerging Asia, have greater growth potential and trade at cheaper valuations than US large companies. We intend to make these shifts as opportunities arise in what we expect will be a more volatile year for markets.

In addition to seeing more variation in their monthly portfolio statement balances, clients should expect returns to be subdued when compared to 2017. Typically, years of low volatility and high returns have been followed by years with increased volatility and modest or negative returns. As always, we remain vigilant for opportunities and we monitor economic indicators and markets closely in order to continue protecting and growing our clients' wealth.

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