AMB Newsletter
1st Quarter 2018

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4th Quarter Review 2017

Global equity markets had another strong quarter to put an end to a very prosperous 2017, a year in which the S&P 500 posted a positive return every month. The robust earnings reported during the year, paired with a positive economic backdrop, helped push risk assets higher across the globe. Since the recession, 2017 was the first year to have seen a coordinated global acceleration on the economic front, which helped earnings and revenues for companies worldwide. Not only were returns very strong, but volatility was very low as well. The maximum drawdown on the year was approximately 3% for US equities. This was a year when downside risks from politics around the globe failed to materialize but upside risk; i.e., the tax bill, did.

To say 2017 was the year of growth is an understatement as value stocks underperformed their domestic counterparts by a whopping 1000 bps. U.S. technology stocks rose approximately 40% in 2017, making information technology the heaviest weighted sector in the S&P 500, which helped push the total return for the market over 21% for the year. Information technology was not alone in the rally, as it was very broad-based with consumer discretionary, healthcare, financials, and materials all returning upwards of 20% for the year; however, as we predicted at the beginning of the year, defensive sectors such as utilities, staples and telecom lagged for the year.

International markets posted a very strong year as well, which was led by emerging markets measured by the MSCI EM, which posted a return of 37%. This was attributed to several factors, such as a weak dollar that has historically led to strong relative performance, and that is exactly what we saw in 2017. Emerging markets also benefited from earnings comparables this year, being measured against a low base year of 2016. Other factors, such as a rebound in commodity prices throughout the year also benefited emerging markets as most of their economies rely heavily on the exportation of natural resources, such as copper and oil.

Developed international equities, measured by the MSCI EAFE, had a solid year as well with a return of approximately 25%. The EAFE started out with a bang, but the European markets lost steam going into the end of the year for several different reasons: political unrest in the Spanish province of Catalonia, a strong Euro, and Europe has also not received the same type of political upside as the U.S. in the form of tax cuts to boost corporate profits. Despite this, AMB expects continued outperformance from international markets in the coming years, as we believe they are still in the early stages of their economic expansion relative to the U.S.

Going into 2017, the U.S. Federal Reserve was the only central bank to begin a cycle of interest rate hikes, and it was also the only central bank to have a hawkish stance. This remained true for most of the year, but we have begun to see more hawkish moves begin to emerge around the globe. The ECB reduced its bond purchases down to EUR 30 billion per month. Encouraging economic data seemed to push this move along with legal constraints concerning the amount of German Bunds that could be purchased. The Bank of England raised rates for the first time since 2007 but stated that any further rate increases would depend upon Brexit negotiations. In light of these decisions, rates in the U.S. have started to move higher, especially on the front end. AMB expected rates in the intermediate to longer end to remain subdued due to a culmination of factors, which turned out to be the right call. Last year was a volatile year for rates; however, returns in the fixed income market remained steady, posting a mark of approximately 2%, measured by Bloomberg's Barclays Intermediate Government Credit Index.

1st Quarter 2018 Outlook

Economy

The world economy broke out of its malaise in 2017 and is finally outpacing most predictions. AMB expects this trend to continue going into 2018 and beyond. In our view, the economy will be driven by continued easy financial conditions and some overdue support on the fiscal side. A big step in fiscal reform, which has been missing since the great recession, was the passage of tax reform in the U.S. at the end of 2017. These reforms should add to the bottom line of most companies beginning in 2018, and we will hopefully begin to see fixed capital investment and an increase in wages that we desperately need. AMB expects to see above trend growth in most developed markets in 2018, and we do feel this will spill over into emerging markets as well. Our main concern is the effect the U.S. Federal Reserve's policies will have on the rest of the world. A continued hawkish stance will more than likely be offset in the other developed countries due to currency moves, but emerging economies who keep most of their reserves in U.S. dollars could be hampered by continued rate hikes in the U.S. As for a global recession in the near future, AMB suspects that this is very unlikely.

U.S. economic growth picked up the pace halfway through 2017 as economic growth topped 3% for the 2nd, 3rd and expected 4th quarters compared to the average 2.2% experienced since 2009. The economy got a boost from a tough hurricane season in 2017, along with confidence that deregulation in key industries paired with tax reform would come to pass in the near future. Moreover, the real question remains how will the U.S. be able to continue this pace of growth? AMB believes the U.S. can sustain such growth in 2018 but will be slower in subsequent years for several reasons. The absence of wage growth, tighter monetary policy, an aging population, and capacity utilization being nearly exhausted are a few of those reasons. AMB expects longer run GDP to be closer to 2%.

AMB expects strong growth in 2018 because of deregulation and tax reform, but wages continue to be our key indicator for sustained growth and inflation in the US. Thus far, what we wrote last quarter still rings true. The employment situation in the U.S. continued to improve in 2017; however, AMB's most favored indicator, wage growth, is still not improving at our desired pace. The difference in hiring demand and wages paid continues to grow. As we have mentioned many times in a service driven economy, wages drive growth and inflation. Without the push of wage inflation, the economy will not be able to sustain its current level of growth. AMB has continued to express the fact since 2009, the type of jobs being added to the economy are part-time, low paying jobs, which are not the type that would drive significant spending going forward.

When we look onto the horizon and try to pinpoint the driver of future growth in the U.S., it still falls squarely on fiscal policy in our view. Monetary policy measures have been exhausted and are now being reeled in and favoring measures of tightening. Moving into 2018, reforms on ACA, taxes, and other burdensome regulation will be key for domestic growth. As the reforms are put into place, AMB is hopeful that wage inflation will be able to take hold and continue to push domestic growth.

Equity Market

For the majority of all risk asset investors, 2017 was an abundantly rewarding year. Investors in the U.S. have enjoyed a bull market in both equity and fixed income asset classes for close to a decade. Many AMB clients have asked if we think 2018 is the year the bull market ends? Our answer is currently a resounding no. AMB believes the equity markets are in the latter stages of a bull market, but 2018 could be very rewarding once again. Recently passed tax reform should help boost profits on the top and bottom line, which should increase the valuations of many U.S. companies. AMB also predicts that 2018 will be a year where continued deregulation across all industries will help boost future profits.

The takeaways from our previous two letters is still very relevant going into 2018. "Recently, the current market valuations are the questions most frequently asked by clients. Are stocks overpriced? Is the market in a bubble? When can we expect a correction? These are pertinent, important questions; however, in AMB's view, one of the most bullish signs for the equity markets is the fact that these types of questions are being asked. Bull markets do not end during times of cautious mentality but rather during times of extreme euphoria. We continue to forecast that we are in a bull market that has shifted from being driven by interest rates and low inflation to being driven by higher earnings. Earnings seemed to have bottomed in the summer of 2016, and that has been reinforced by 1st and 2nd quarter earnings in 2017." Now we can add 3rd quarter earnings as well, and with U.S. operating profits continued improvement YoY throughout 2017, AMB expects this will continue in 2018.

Equity Market (Continued)

Heading into the 1st quarter of 2018, AMB believes sector allocation is going to be of upmost importance throughout 2018. We have seen stock correlation inside sectors continue to increase over the years and expect that to continue in 2018. Investors need to be positioned in the sectors that are going to benefit most from the Trump Administration's policies. Currently, the main benefactor is financials, in which we hold an overweighed position. Equity performance for 2018 is going to be dependent upon interest rates, inflation, and earnings. If rates start to rise in the U.S., at what point will it hamper equity performance? This is a question we hear quite often, and AMB foresees that if rates increase for the right reasons and rise at a slow pace, that it will not hamper performance in the equity markets. In our view, the right reasons for rate increases would be a stronger than expected economy, and inflation will also play a major part. Increasing inflation, as long as it is at a steady pace, should benefit U.S. companies by increasing the top line and would outpace wage inflation. Earnings are always going to be a major factor in equity performance, and as we all know, a stock price reflects future cashflows that are discounted to present day dollars. If the expectation of future earnings move higher, so will equity market prices.

Non-U.S. equity also performed very well in 2017. A weakening dollar pushed emerging market assets higher, which was evidenced by emerging market returns (measured by the MSCI EM Index) of 37% for the year. International developed markets (as measured by the MSCI EAFE Index) also posted strong returns with a very respectable 25%. International equities were well positioned for a good year based on relative valuations, a weakening dollar, and a continued economic recovery. Fundamentally, developed international equities remain undervalued compared to their U.S. counterparts, and they are just in the early stages of their recovery, which we think has years left to run.

Fixed Income

Equity markets had a historically stable year, never falling more than 3% in 2017. On the other hand, fixed income markets more than made up for that lack of volatility. When looking at the starting indicator for 2017 and where it ended the year, one would think rates were rather stable, but that is far from the truth. The 10-year Treasury moved down to a low of 2.03% during the year, then back to over 2.4% in just the last two quarters alone. On a total basis, this doesn't seem like much, but in percentage terms this was over a 20% move in the 10-year rate. Even with this move, most fixed income accounts still posted positive returns for 2017, with the market measured by the Bloomberg Barclays Intermediate Government Credit returning 2.12% for the year.

Heading into 2018, AMB's outlook for fixed income has not waivered. We still think that rates on the front end will continue to move higher with monetary policy continuing to tighten, which is the reason we have been underweight or void the front end for the past few years. AMB still recommends being overweight in the intermediate to longer end of the curve. We suppose a number of factors will play a role in keeping a cap on rates, one of the main reasons being international rates are still well below rates here in the U.S. Due to this variance, we should continue to see strong international demand for our paper keeping a cap on rates. AMB also expects inflation and growth in the U.S. will pick up in 2018 but waiver in the following years. We predict long run GDP will average approximately 2%, and unless we begin to see wage growth, AMB does not believe inflation will take hold. For these reasons, the intermediate area of the curve remains more appealing.

We also need to remember why we invest in fixed income. It is not the growth engine of our portfolios, but it is what brings stability and predictability to them. Using a buy and hold strategy, interest rate movements are irrelevant, as we are investing for a stream of cash flows, and the safety of principal, which will be repaid upon maturity as long as the bond is credit worthy. Pundits that speak to fixed income being riskier than the stock market are making a generalized blanket statement that we feel is not accurate. Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part of every portfolio in some facet.

Conclusion

With 2017 in the rearview mirror, AMB expects that 2018 will continue to harbor the necessary conditions for the bull market, which many investors have enjoyed for nearly a decade, to continue. With the passage of tax reform at the tail end of last year, AMB is looking for this boost in fiscal policy to take effect in 2018, adding to the bottom line of many domestic companies. The market is likely to continue to ignore global and political tensions as it did in 2017 and remain earnings driven. With the potential boost in earnings due to the tax reform and earnings being a key driver in market performance, AMB sees 2018 as a potentially strong year for investors.