Market Review and Outlook—December 6, 2017

We are Closing in on a Great Year for Investors The table below shows one-year returns of about 4% for bonds, 20% for US stocks and almost 30% for foreign stocks. Those investors with a 60% level of stocks have earned over 13½% during the past year. The 11-month year-to-date figures are not far behind. This is excellent.

While foreign stocks have led the way for much of the year, in the past three months US stocks have led. Much of this is due to the corporate investor pleasure with the GOP Tax Bill which is on course to become law later this month. This is a major piece of legislation, and a major accomplishment for the Republican Congress and the President, and is expected to boost short-term profits for US companies.

Looking Good Globally Economies throughout the developed and developing world look uniformly solid. There aren't any regions with broad weakness. There is a second element to consider however, price. Growth can be expensive in one area and cheap elsewhere. We find stock prices beyond the US are more reasonable.

Bond Markets Are Really Under Pressure We have warned for years that bond prices were very high and due for a reckoning. The day of reckoning, however, requires a very solid economy, and we now have that. In fact, the new tax bill could hasten the downward pressure on bonds, as interest rates are expected to rise at a faster pace under the new legislation. While we never like losses, in the table below the two bond lines' three-month losses are very modest, and the longer-term returns are all positive. We expect very low returns from bonds for several years, and it could be a bit rough over the next year as investors take time to determine how the tax legislation will affect interest rates over time.

Rebalance, Please Given the very strong returns of the past year, it is critical that investors rebalance their portfolios to avoid a sharp build-up of risk by failing to harvest and lock in strong 2017 gains. Even in taxable accounts, rebalancing is worthwhile, as the income tax cost can be outweighed by the elimination of the increased risk of a sharp stock price pullback. Enjoy this strong year of performance, but follow up by rebalancing, to get your portfolio prepared for 2018. Lock in those gains!

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Govt Cash Reserves	+0.18%	+0.50%	+0.20%	+0.12%	+0.46%
Intermediate Term Bond	-0.46%	+3.57%	+2.05%	+1.98%	+4.03%
Intermediate Muni Bond	-0.83%	+4.65%	+2.18%	+1.91%	+3.59%
Large-Cap Stock	+7.60%	+21.06%	+9.18%	+14.23%	+7.42%
Mid-Cap Stock	+8.42%	+16.86%	+8.12%	+13.66%	+7.73%
Small-Cap Stock	+10.25%	+16.03%	+9.54%	+13.75%	+8.14%
Foreign Large-Cap Stock	+4.42%	+25.95%	+5.87%	+7.70%	+1.43%
Foreign Small/Mid Cap Stock	+5.35%	+30.83%	+10.90%	+11.17%	+4.64%
Diversified Emerging Markets	+2.55%	+29.73%	+4.91%	+4.47%	+1.33%
Technology	+8.78%	+36.77%	+16.68%	+20.17%	+10.45%
Real Estate	+1.84%	+10.43%	+5.65%	+9.39%	+6.21%
Natural Resources	+7.13%	+13.05%	+2.56%	+2.48%	+0.55%
Moderate Allocation (50-70% stocks)	+3.84%	+13.56%	+5.32%	+8.03%	+5.40%

The data in this table comes from Morningstar and is as of November 30, 2017

The US stock market is at least modestly overpriced the past three and twelve months, which is a welcome change. Unlike US stocks, foreign stocks have far to run before setting records, have more apparent downside protection, and generally are supported by stronger economic growth. Due to this global economic growth, foreign emerging markets are on fire, rising over 8% in three months. There are certainly geo-political clouds on the horizon, but the economics and valuations provide a comforting backdrop for investing in foreign stocks.

The New Normal, for Bonds? Bonds returned less than 1½% over the past year. As interest rates have fallen steadily since 1981, the most likely best news for bonds is no change in interest rates, in which case you earn simply the interest. If, however, rates rise, then prices fall, eating into your return, as we have experienced since December. The Federal Reserve Bank has years of 'unwinding,' selling their vast reserves of bonds they purchased during the downturn and recovery to shore up the US economy, and this will provide years of headwind for bond investors. Thus very low returns are likely for bonds for several years.

US Promise and Concerns The US economy continues to expand, and expand broadly, although the pace is very modest. While US stock levels are near record levels, so are their earnings, and therefore we are not alarmed. Of concern, however, is that several of the markets' hopes from late 2016 appear unlikely to come to pass—massive infrastructure spending, individual and corporate tax reform, sharply reduced regulations. There is a risk that US stock investors will see their hopes diminish and concerns rise, leading to a broad pullback of US stocks. While I don't foresee a recession in the next year, a market decline is certainly possible.

Hedges Investment hedges (real estate and natural resources) are like fire insurance—you don't want it to pay off but you still need it. Our foreign and US stocks have been doing quite well in the past three and twelve months, and therefore it is neither surprising nor concerning that our hedges have not done well. They are designed to provide a boost should inflation surge upward, to compensate for falling stock prices.

Rebalancing With such strong recent gains by foreign stocks, rebalancing appears timely.

Our first investment principle is incorporating a very deliberate, transparent level of risk in a portfolio. The second is to regularly rebalance, especially when markets have swings. The table below shows the big variance between US and foreign stocks. This presents a prime time to rebalance, and thus 'sell high and buy low.' You may end up 'picking the flowers and watering the weeds,' however when regularly done, such rebalancing enables you to avoid the painful corrections (such as the dot-com bust of 2000 and financial sector meltdown of 2008). While we see a lot to like in foreign stocks, "enough is as good as a feast." Rebalance.

One year ago, all ten stock categories in the table below showed losses for the past three months and one year (as shown on the next page). Every one. Emerging Market stocks were down 21½%, Natural Resources had fallen over 27½%. Taxable bonds were up 3% while muni bonds were down slightly. In this report the opposite is the case. EVERY ONE of the ten stock categories shows gains in the past quarter and year. Emerging Market stocks are up 25½% and Natural Resources gained over 34%. Muni bonds are up 3% while taxable bonds are down a fraction.

Why? Let's start with oil. Oil fell to $31 a barrel in January 2016, lower than during the 2008-2009 financial crash, lower than it had been for well over a decade. This dragged down earnings for the S&P 500 stocks by over 20%, and stock market values tumbled. Fast forward to February 2017 and oil has risen 70% (yes, 70%) to over $55 a barrel, and S&P 500 earnings are expected to come in 20% greater than a year ago.

The surprising November election results also have boosted stocks, both US stocks and, more recently, foreign stocks. For the first time in six years we have one party controlling the White House and Congress, and the first time Republicans controlled both in eight years. US investors are looking for higher economic growth and profits resulting from expected lower regulations, and also from the Trump Administration's push for significantly boosted spending on infrastructure. Global manufacturers are confident in the future across the globe, for the US, for developed markets (including Europe), and even for emerging markets (except for Brazil and Greece). Their level of confidence is substantial.