Q4 2017 Review

The market in 2017 could be best described as near perfect. Every major equity market in the world, with the exception of Russia and Israel were up for the year and every major asset category was positive except for the U.S. dollar. All of this on the back of the most synchronized global expansion since before the great recession. Markets were so perfect, that the S&P 500 was up every month of the year leading to the least volatile year ever. The VIX (measure of equity volatility) experienced an average daily closing price of 11.12 versus a typical year where it is over 20, and the S&P 500 did not have a single day where it was down 3% or more.

We saw the beginnings of what is likely a global change in easy monetary policy. The Fed continued to tighten at every quarterly meeting. Three times the Fed raised rates, and during the second quarter (in which they did not raise rates) they began their program to reduce its bond holdings. During the fourth quarter, other central banks began to indicate that they would likely soon follow. Global synchronized growth and the fear of being behind the curve in keeping inflation in check gives them room to begin to normalize monetary policy. The sentiment has changed from preventing deflation and stagnant growth to one that is becoming cautious of inflationary pressures and unsustainable asset valuations.

The final month of the year saw at long last the tax cut that had been promised. Markets were believers fairly quickly, even anticipating it for most of the final quarter. Experts are somewhat mixed, with predictions of .1% to over 1% additional GDP growth in the U.S. from the tax cuts. While there are many skeptics on the personal tax cuts, most everyone sees the corporate tax cuts as a positive. The corporate cuts are likely to translate into more capital expenditures and stock buybacks, with the possibility of higher wages. It is hard to imagine that 2018 will be as perfect as 2017, and most investors would be happy with a high single digit equity market return.

Asset Class Returns, 2017

<table>
<thead>
<tr>
<th>Index</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P GS Commodity Idx</td>
<td>11.11%</td>
</tr>
<tr>
<td>HFRI Hedge Fund Idx</td>
<td>8.68%</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>14.65%</td>
</tr>
<tr>
<td>MSCI Emerging Mkts</td>
<td>37.28%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>25.03%</td>
</tr>
<tr>
<td>Barclays Aggregate</td>
<td>3.54%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>21.83%</td>
</tr>
<tr>
<td>Barclays LT Treasury</td>
<td>8.53%</td>
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</tbody>
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Source: NDR
Equities

Equity markets overall had a remarkable year with international developed and emerging markets having an even stronger year than U.S. stocks. While continued easy monetary policy worldwide and low interest rates were a contributor, underlying fundamentals were also strong. According to Factset, 2017 is likely to finish with U.S. earnings growth of between 11% and 12% and revenue up 7% to 8%. Global output continues to strengthen, with virtually every major economy seeing positive growth.

Within U.S. stocks, we continued to see growth substantially outperform value and large caps outperform small cap. Large cap growth outperformed large cap value by over 18 percentage points for the year pushing the divergence to the widest range since the 1999-2000 technology bubble. Large cap stocks continued to outperform small cap stocks, despite the original thesis that tax cuts would benefit small caps more. Small caps have lagged as they are perceived as more expensive and likely to face headwinds with tightening credit conditions going forward. International markets outperformed U.S. markets for the first time in 5 years with emerging markets finishing the year even stronger. The top reasons for the shift primarily have to deal with better valuations overseas, a weak dollar, and global growth. Many portfolios have been heavy U.S. stocks and will have to rotate to gain any significant exposure.

At this point in the cycle, the talk of valuations and bubbles start heat up. While it is true that the overwhelming number of statistics that are widely followed show extreme valuations, some of those same statistics have historically shown valuations can continue to climb. One statistic that looks extreme is margin debt. Margin debt is leverage taken on an equity portfolio by retail investors. The dollar amount of margin is at an all time high which would indicate that less money is available to push equity markets higher. While it is true that margin debt is at an all time high, equity valuations are also at an all time high. The relevant statistic would be margin debt divided by market valuation. The chart below shows margin debt to U.S. market valuation plotted with the S&P 500 and Central Bank assets. In the two previous bull market tops, 1999 and 2007, we can see that the ratio of debt to market value increased rapidly leading up to the top. Today, we have seen the S&P 500 move up significantly while the margin debt to equity value has been stable and even declining slightly. What is different than the previous two periods is that Central Bank assets have increased dramatically while equity values have increased. While Central Bank assets are less volatile, they are also substantially larger (on a magnitude of over 10x). What this represents is how much of an influence monetary policy through Central Banks have had on asset values. To what magnitude and speed will their balance sheets contract is by far one of the most significant statistics that we will be watching closely.

We continued to maintain an overweight to large U.S. stocks, while gradually moving more towards international stocks in 2017. Our managers have been focused on quality stocks and have a valuation discipline. While not keeping up with the high flying growth names, they all had a good year and are positioned more defensively than the overall market. We are likely in the phase of the bull market where quality and valuation discipline provides a better risk reward. Active management, which we have been underweight the past year, is starting to look more appealing as S&P stock correlations (average correlation of one stock to each other) have fallen back to levels last seen in the mid to late 1990’s. That was a very good stretch for active management. We are still cautious due to the increased shift to passive strategies and difficulty of producing outperformance relative to a benchmark. We seek managers who we believe have the best chance of producing returns above their benchmark over long periods of time, but the number that consistently outperform is relatively small.
Fixed Income

Tightening by the Fed had the 10 Year U.S. Treasury bond yielding 2.46% at year end and the yield curve the flattest since 2007. The Fed raised rates three times during the year and made the first decision on normalizing their balance sheet going forward. Coming into 2018, there is a building confidence that inflation will get to the Fed’s target of 2% and rates will gradually move higher. Unemployment is back to record low levels and with corporations indicating a willingness to invest in growth we will likely start to see wage pressures begin to build. As we have shown in previous letters, wage growth is very highly correlated with increases in the Fed Funds Target Rate.

The municipal bond space saw some interesting action late in the year as the new tax legislation was being hammered out. Originally, Private Activity Bonds (PABs) were going to lose their tax exempt status. PABs are used to help fund infrastructure projects, such as toll roads and airports. They make up about a third of municipal bond issuance. To front run the possible legislation, issuance reached a record high in December causing municipal bonds to increase in yield. After the legislation passed without any changes to the tax exempt status, municipal rates began to normalize.

Source: Bloomberg
Going Forward

Many investors find the current environment a conundrum as valuations, on most measures, are at historical highs while economic growth and earnings continue to strengthen. It is very difficult to know if we are in an environment similar to 1995-1998 and 2004-2006, or an environment like 1999 and 2007. The fear of another 2008 still lingers in many minds, though less so as the years roll on. Most forget that we typically have good old fashion pullbacks and bear markets in the order of 5%-20% that are very difficult to predict. We view market timing as a fool’s errand, as one has to be right twice and take into account the taxes of selling out of a portfolio and going to cash. The better long term approach is to build a portfolio that can be maintained based on the underlying client’s time horizon, taking into account market volatility. With this approach it is important to constantly be looking at diversification and new ways to improve portfolio construction. Another example of why it is difficult to call market tops is in the chart below. Many see a flattening yield curve as indication that a recession is eminent. It is true that the past three recessions have seen the yield curve flatten and invert, but it is also true that PMI (Purchasing Managers Index) dropped below 50 prior to a recession. Taking those two indicators into account, a recession is not a given over the next 12-18 months. The yield curve flattening then quickly steepening, is a good sign to watch for that the Fed may have gone too far.

We continue to favor quality municipal bonds as the core of our bond allocation. For most of 2017 we had an investment grade corporate bond allocation to help hedge out the risk of tax legislation that might affect the tax exempt status as well as the possibility of quality corporate bonds benefiting from an elimination of interest expense. High yield is an area we continue to avoid as the risk return profile continues to worsen. As you can see in the chart below spreads relative to U.S. Treasuries are back down to the record lows prior to the two previous bear markets. We prefer to take risk in equities and use bonds for income and diversification and not just income.

Source: Bloomberg

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Please refer to important disclosures on the last page.
Alternatives are a good source of diversification for a long term portfolio. We continue to see the turn in hedge fund strategy performance relative to equity and bond returns after a pretty tough stretch. Absolute return strategies will provide a cushion if we get into an environment of equities and fixed income coming off of historically high valuations. Our long short fund has an average manager market exposure of around 50%, as they have short positions to offset their long exposure. The environment for stock selection has been improving and will likely provide a good risk reward relative to long only indices going forward. In regards to private equity, we saw our managers have some good success early on with realizations in the order of 2.5x to 3x as money continues to pursue private opportunities. As we have mentioned we are focused on smaller and more disciplined managers who won’t chase the valuations, but rather wait for the right opportunities. In looking at data from Cambridge Associates, we see that private equity provides the best relative return during periods of flat to declining equity markets. 2018 will be a year where investors and allocators will need to be disciplined and likely work a little harder to realize acceptable risk adjusted returns.

Source: Bloomberg
Disclosures

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