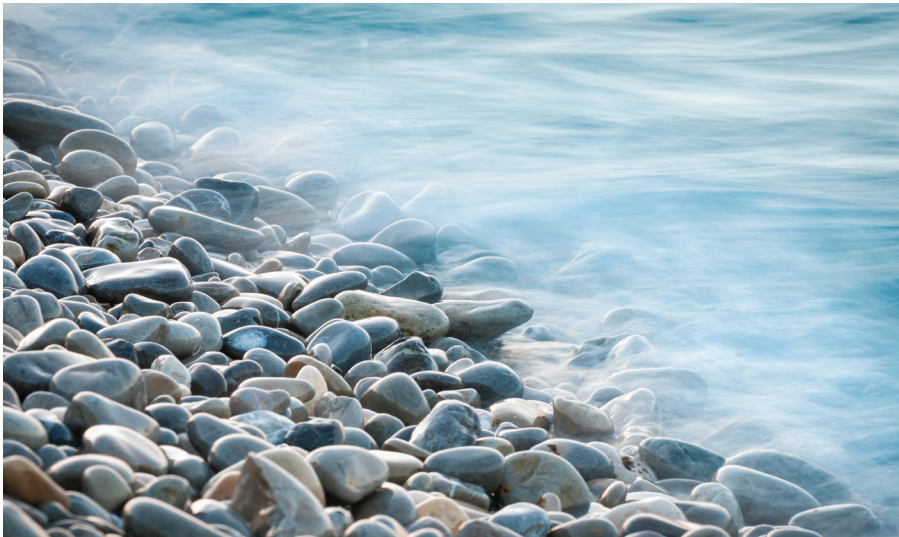


Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



Silencing the Skeptics

“Progress doesn’t always go the way we expect it to. It is sometimes wiser than we are.”
—David Brin

THE GLOBAL ECONOMY ENTERS 2018 at its strongest point in more than a decade. The U.S. is enjoying low unemployment, strengthening exports, higher levels of private investment, and stronger levels of consumer and business confidence. In Europe, after nearly a decade of sluggish performance, the economy is picking up, propelled by a surge in business sentiment and looser credit conditions. Japan remains troubled by soft wages and low consumer spending, but is still trying to boost its economy through stimulative measures. Many emerging markets are seeing strong levels of coordinated growth as Brazil and Russia emerge from oil-related recessions and China continues to migrate toward a less investment-based economy.

Recent growth momentum provides a strong ramp into 2018. Moreover, easy financial conditions (reflecting buoyant markets for risk assets and still-low interest rates) imply sustained near-term tailwinds, and fiscal stimulus is picking up with tax reform in the U.S., Abenomics in Japan, and the prolonged stay on fiscal austerity in the Eurozone. Meanwhile, China keeps suppressing domestic economic and financial volatility while fundamentals in many other emerging market economies continue to improve.

Yet, with the S&P 500 at 2,800, and a year after global equities, as measured by the MSCI All Country World Index (ACWI), rose close to 24%, many fear the stock market has reached bubble terrain, pumped up

IN THIS ISSUE

1

The global economy enters 2018 at its strongest point in more than a decade, and though markets enjoyed heady returns in 2017, are on pace for more. The primary risk factors globally revolve around monetary policy, trade policy, populism and politics, and geopolitics.

2

U.S. economic data remains solid, and corporate earnings momentum is strong heading into 2018. Tax reform should provide an extra leg up for corporate earnings and support consumer spending.

3

Europe has a steady earnings outlook despite euro strength. Japan has been buoyed by more shareholder-friendly corporate behavior and solid earnings amid a stable yen. The UK is a wild card given Brexit-related uncertainty.

4

Above-trend expansion in the developed world, economic reforms, improving corporate fundamentals, and reasonable valuations support emerging market equities. Risks include a sharp rise in the U.S. dollar, trade tensions, and elections.

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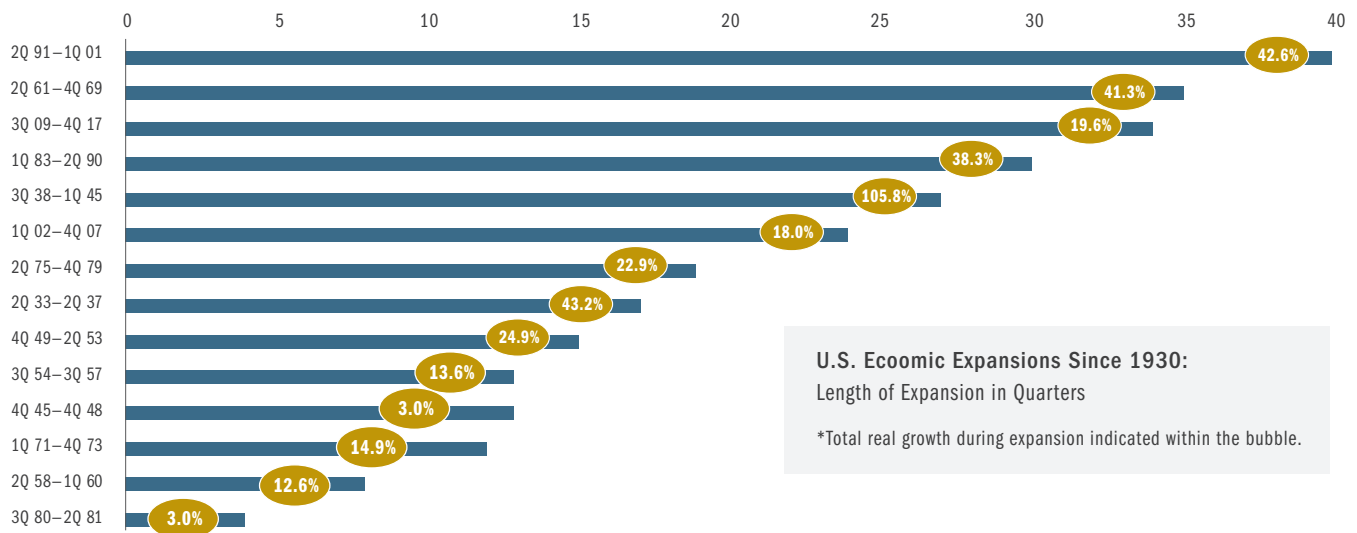
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It Ain't Over Until It's Over (and while long, this expansion has been weak in terms of growth)



by artificial and unsustainable monetary stimulus. This fears are exacerbated against a political backdrop rife with uncertainties that range from Brexit, Catalanian independence, North Korea, and all things Donald Trump.

While we acknowledge that absolute market levels are high, underlying economic and corporate earnings fundamentals are truly strong. To us, the recovery from the 2008 Great Recession is not long in the tooth, but rather has matured into a structural expansion of economic activity, profits, and employment that may have more years to run. Given the extreme credit crisis that caused the Great Recession, the recovery was sure to take some time, and appears to have finally reached sustainability. Yet skepticism abounds, and has many investors on tenterhooks about the future.

For sure, a healthy dose of caution in investing is always a good thing, as well as strict adherence to disciplined and prudent rebalancing, especially in a runaway market. While bond returns have been unappetizing compared to the juicy gains of the stock market, the fixed income asset class offers a means to dampen portfolio volatility. And in the context of a slowly rising interest rate environment, bonds have been a much better investment than stockpiling cash.

Turning back to the question of skepticism over current equity market levels, it is

worth considering a few of the positives that are being overlooked in the rush to discredit and disavow the market's future potential.

First and foremost, the world economy is firing on all cylinders, with the U.S., Europe, and China simultaneously experiencing robust economic growth for the first time since 2008. Though in a normal cycle these simultaneous expansions might spark inflation and higher interest rates, spare capacity remains in most advanced economies, which, coupled with persistent deflationary pressures from technology and global competition, significantly reduces the risks of overheating.

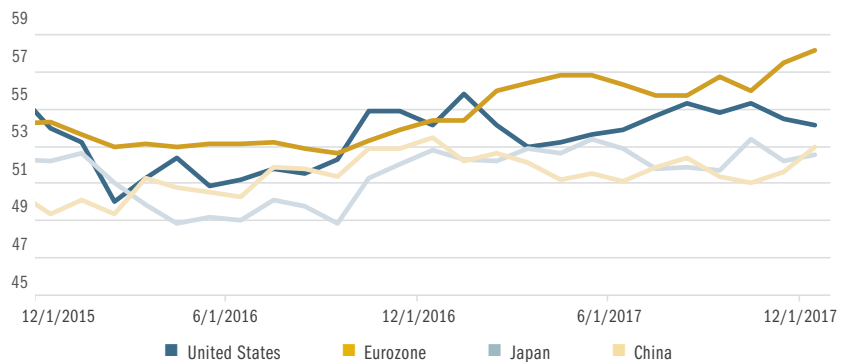
For this reason, and given the lack of evidence of inflation, central bankers have been only slowly and methodically tight-

ening monetary policy, if at all. Indeed, it is entirely possible that very low interest rates will persist at least until the end of this decade. As for how this translates to the stock market, higher interest rates lift the discount rate applied to value the future cash flows of a company, and thus lower the fair value of the stock. Therefore traditional price-to-earnings metrics work best in a normalized interest rate environment, as comparisons to historical averages ignore the current economic and interest rate backdrop. In a low-rate, low-inflation environment as we have now, valuations may be above their long-term averages but may stay that way for quite some time.

However, and this point cannot be emphasized enough in a market with the

World economy firing on all cylinders with global composite PMIs all trending above the 50 mark that signifies expansion

Global Purchasing Manager Composite Index



distortion of low interest rates that we are experiencing today, it is a good rule of thumb to apply some active management to your stock selection, so that a fundamental stock picker is able to separate the wheat from the chaff among the arguably overpriced companies available for purchase. In contrast, a low-cost index approach that buys the market indiscriminately is an easy choice when markets are undervalued by conventional and historical metrics, but is a much more risky proposition when those metrics are flashing red.

Another reason for confidence is the coordinated and confident handling of quantitative easing by global central bankers, which has been and continues to be incredibly effective in supporting the world's economy and financial markets. And, despite resounding skepticism and dire warnings of impending doom, has not seeded the makings of the next global financial crisis. On the contrary, experimental monetary policy has been the lynchpin of the global recovery from the Great Recession, with the U.S. at the forefront with zero interest rates and QE. While naysayers continue to argue these monetary policy tools are akin to an illicit drug that the addicted U.S. economy can't live without, they ignore the reality that the Fed began to reduce its purchases of long-term securities at the beginning of 2014, stopped QE completely later that year, and started raising interest rates in 2015—all without producing the “cold turkey” side effects predicted by these skeptics. Instead of falling back into recession or secular stagnation, the U.S. economy continued growing and creating jobs as the stimulus was reduced and then stopped. And asset prices, far from collapsing, hit new highs and accelerated upward from early 2013 onwards—exactly when the Fed started talking about “tapering” QE.

Using the U.S. roadmap, other countries have followed suit, but with long and variable lags, and with what we would expect to be similar side effects and withdrawal plans. Japan started full-scale monetary stimulus in 2013, five years after the Fed. Europe lagged by seven years, starting QE in March 2015. And in many emerging economies, monetary stimulus and

economic recovery only began this year. Importantly, business cycles and monetary policy are less synchronized than in any previous global expansion. This is a truly “Goldilocks” scenario for investors, especially those who use a diversified approach in their allocation to equities that spans companies from around the globe. Now more than ever before, we can expect more differentiation and less correlation of returns, and perhaps more muted risks than in past cycles.

As investors struggle to accept lower market volatility and decry valuations and imply complacency, they may be overlooking the benefits of decoupled monetary policy and lagged expansions. While the Fed is raising rates now, Europe and Japan are like to keep their near zero at least until the end of the decade, which will moderate the negative effects of U.S. monetary tightening on asset markets around the world and even keep a ceiling on U.S. long-term rates. Likewise, the upward price pressures normally created by a synchronized global expansion are being muted as European and Asia economies are just beginning their recoveries, in contrast to the U.S. which is in a more mature stage.

Similarly, corporate profits are showing the benefits of this staggered effect. While U.S. corporate profits, which have been rising for seven years, may have hit a ceiling, the cyclical upswing in profits outside the U.S. has only recently started and will create new investment opportunities. So, even if U.S. investment conditions become less

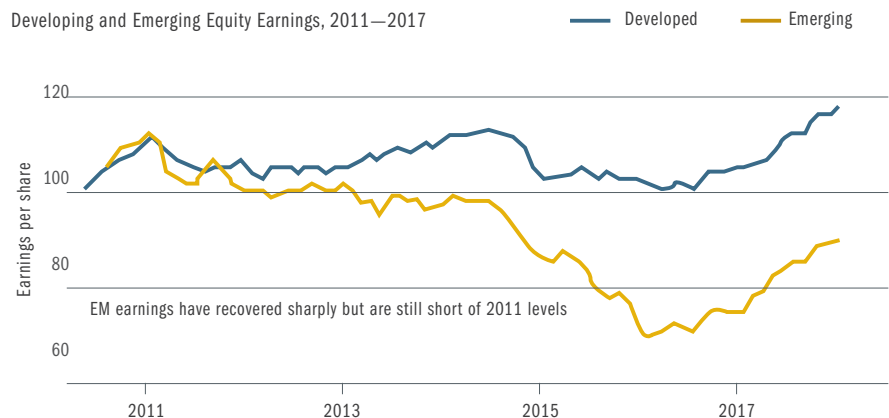
favorable, Europe, Japan, and many emerging markets are now entering the sweet spot of their investment cycles: profits are rising strongly, but interest rates remain very low.

Against this backdrop, therefore, it is reasonable to conclude that the next couple of years look pretty good from a macro standpoint. Even though we have been going at this recovery for eight years, which is longer than almost any expansion, we have not had overinvestment, which is why growth has been lower. But it also takes away one of the prerequisites for a recession. And we must remember expansions do not die of old age. They die because something was in a structural imbalance.

To that point, there are several long-term structural anxieties we would do well to keep track of: rising government debt burdens, weak productivity growth, the rise of nationalism and protectionism, aging demographics, and income inequality, to name a few. The questions and risks these structural problems pose are not so much being ignored by the market, but understood to be more medium- and long-term issues and are not in focus at this time. As markets continue to grind higher, though, we can expect they will come into greater focus, especially as valuations go from the optimistic to the euphoric. Until then, asset prices seem more likely to rise than fall, and skeptics may be destined for another year of dissatisfaction in their wait for the fall.

Earnings recovery continues, with emerging market companies looking to close the gap

Developing and Emerging Equity Earnings, 2011–2017



GLOBAL ECONOMIC OVERVIEW: Solid as a Rock

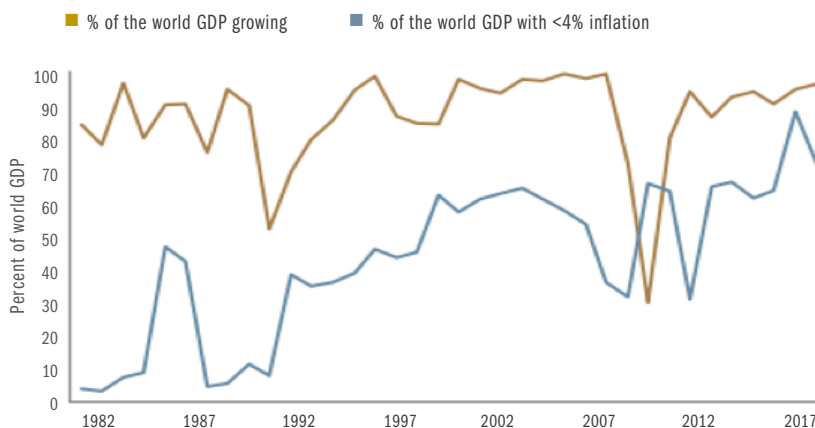
GLOBAL GROWTH SOLIDIFIED IN 2017, with all major regional economies accelerating in unison for the first time in almost a decade. The U.S. economic expansion, which has provided just 2.2% growth per year since its inception in 2009, appeared to pick up its pace in the middle of 2017 as falling unemployment boosted both consumer and business confidence. Real GDP grew by roughly 3% annualized in both the second and third quarters of 2017 and may have risen at a similar pace in the fourth quarter, as repairing, restoring and replacing after a tough hurricane season added to demand. This above-trend pace of growth will continue into the first half of 2018 as lower income tax withholding and corporate tax cuts promote increased consumer and investment spending. Likewise, the global economy should maintain strong growth into 2018. Europe has seen solid improvement over the past year, despite tensions from Brexit and in Catalonia but, with 8.9% unemployment, clearly still has plenty of capacity for above-trend growth. Japan has also had a good year and a lower yen could help maintain economic momentum even though inflation has been slow to respond to very low unemployment. China will continue to emphasize the quality of growth rather than its pace in the years ahead but there seems little reason to fear an abrupt slowdown. And other emerging markets should continue to improve following the commodity

slump of 2015/2016, with a reform agenda in many countries holding out hope for more stable growth going forward.

On a broader level, the withdrawal of global central bank liquidity may be the main test facing the global economy in 2018. While only the Federal Reserve, the Bank of England, and the Bank of Canada have begun raising rates, a number of major central banks will take the first steps in reducing monetary accommodation. But the wind-down of central bank balance sheet expansion should not necessarily pose a significant headwind to global growth. Worldwide, quantitative easing—not tightening—will continue through 2018, if at a reduced pace: from roughly USD \$2 trillion in 2017 to USD \$500 billion in 2018. Furthermore, the slowdown in accommodation will come against the backdrop of a much more balanced global economy. Fiscal conditions have made progress in the U.S. and eurozone periphery, and current account balances in emerging markets have improved, while credit growth has moderated meaningfully.

All of this presents an interesting economic backdrop for investors. In the ninth year of economic expansion, the global economy is in a good place: high economic activity, low unemployment, high levels of profits and low levels of inflation and interest rates. As the year wears on, some of these variables may become in flux, but until then, global growth should remain as solid as a rock.

Global growth with low inflation—things have rarely been this good



U.S. ECONOMY: Tax Reform to Top Off U.S. Growth

AFTER SOME MODEST VOLATILITY in the first half of 2017, the U.S. economy appears to be settling back into the moderate growth path that it has followed over the past several years. We expect growth to run at an annualized rate of around 2.5% to 3% in early 2018, fed by moderate gains in nominal wages and the recent pickup in capital expenditures. Similarly, inflation appears to be stalled at around 2%, which should keep the Federal Reserve on its current gradual-tightening path. Growth statistics for the third quarter of 2017 seemed to show little impact from the hurricanes in August and September, with annualized GDP growth of 3.0% nearly matching its second-quarter pace. Inventory building and an increase in net exports helped compensate for the hurricanes’ impact on manufacturing and consumer spending in the affected regions. It is further notable that there was an increase in inventory building despite a liquidation of retail auto dealer stocks—light vehicle sales spiked to a cyclical high in September as consumers replaced vehicles flooded in Hurricane Harvey. Less encouragingly, consumers dipped into their savings to pay for the new cars, which sent the saving rate to a cyclical low. The saving rate is unlikely to go any lower in coming months, and consumer spending should receive some offsetting support from hurricane-related insurance payouts and tax reform, keeping confidence levels high. And business confidence continues to soar, with the Institute of Supply Management’s (ISM) manufacturing and non-manufacturing surveys both showing continued strength, and the National Federation of Independent Business (NFIB) small business optimism index near cycle highs.

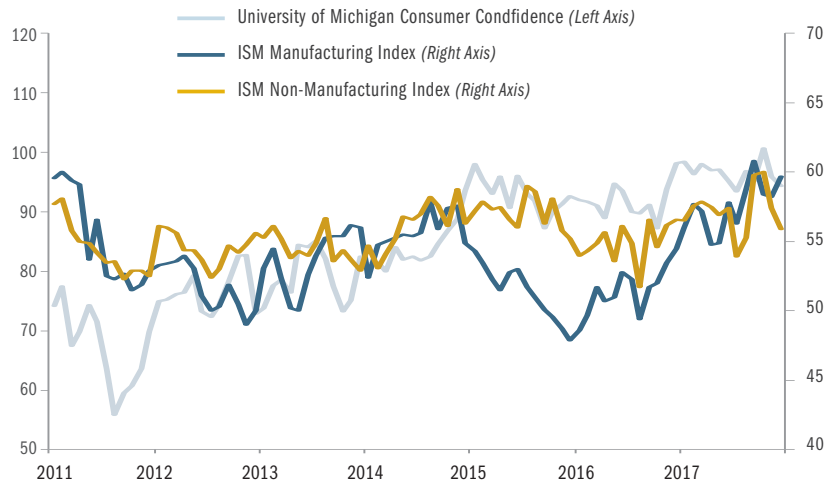
While causing significant temporary disruptions in payroll growth, the hurricanes seemed to have little lasting impact on the overall labor market. Indeed, the unemployment rate has now fallen below its trough during the moderate expansion of the previous decade. We expect the economy to extend its overshoot of full employment in coming months, even as job gains slow, with the unemployment rate falling

to 3.7% by the end of 2018—below even its trough during the robust expansion of the late 1990s. Nevertheless, we are skeptical that a tightening labor market will lead to sharply higher nominal wage growth and push the economy out of its low inflation and moderate growth track. Productivity growth remains well below its levels in the 1990s. Aside from the housing sector, most segments of the economy are seeing minimal price pressures, while the durable goods segment continues to experience outright deflation, fed by global competition, automation, and other pressures. As a result, it seems increasingly plausible that inflation may not reach the Fed’s target of 2% in the personal consumption expenditures (PCE) price index in the current cycle. Notably, policymakers have recently revised inflation forecasts to show a later arrival of inflation at the 2% target.

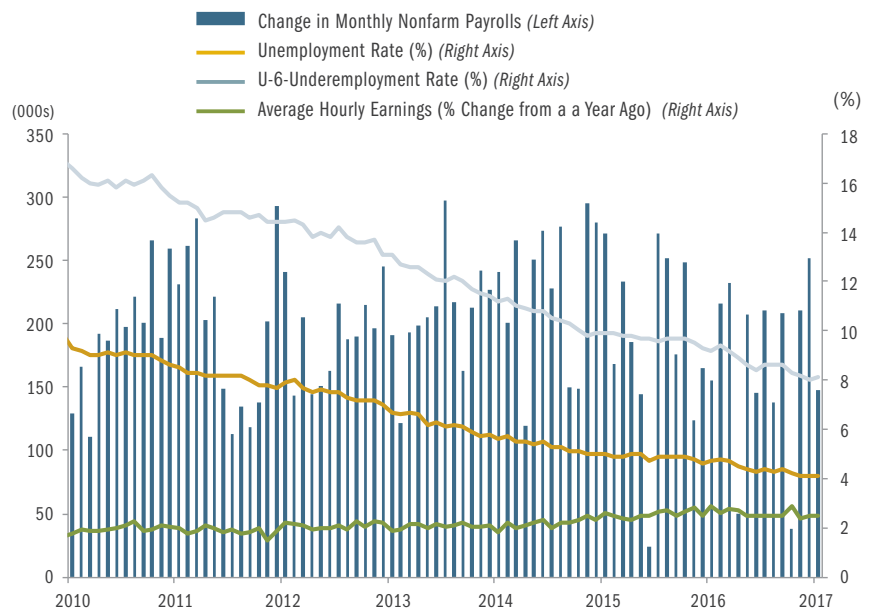
Speaking of the Fed, at the present they are messaging three interest rate hikes in 2018, which will ultimately bring the Fed Funds target interest rate to 2.25% from the current 1.50% level. Fed officials are aware that abnormally low long-term interest rates are fostering inflated asset prices and may pose risks to financial stability if they are sustained. Thus, the Fed is likely to tolerate sub 2% inflation while nudging rates higher, at least until the unemployment rate stabilizes. Newly minted Fed Chairman Jerome Powell has signaled there will be little change in current rate policy under his regime, though he may guide the Fed to adjust its approach to bank regulation. Notably, there will also be at least five newcomers on the seven-member Board of Governors of the Federal Reserve—forming the least experienced Fed in decades.

In Washington news, the Tax Cuts and Job Act was signed into law on December 22, 2017, marking the most extensive overhaul of the U.S. tax system since 1986. For corporations, there was a significant decrease in the tax rate from 35% to 21%, as well as an allowance for businesses to write off 100% of their capital expenditures for the next five years. Individuals will also see tax cuts, including a top rate of 37%, down from 39.6%, though those expire after 2025, a step that Republicans took to comply with budget rules which did not

U.S. consumer confidence stays high while business activity doesn’t miss a beat



U.S. unemployment rate expected to fall even lower in 2018, but wages remain sticky on the downside



allow the package to add to the deficit after a decade. The size of inheritances shielded from estate taxation has doubled, to \$22 million for married couples, and owners of pass-through businesses, whose profits are taxed through the individual code, can now deduct 20% of their business income. These provisions, among others, are expected to boost GDP growth by at least 0.5% in 2018 by driving enhanced consumer spending, spurring hiring and wage increases, and

fueling corporate investment and M&A activity, particularly as a result of a provision allowing offshore cash repatriation.

Finally, at press time, Trump and Congress were struggling to pass a budget deal that has resulted in a government shutdown. At stake is the question of the Deferred Action for Childhood Arrivals (DACA) policy that allows undocumented immigrants who entered the country before their 16th birthday to receive a renew-

Summary of Tax Cuts and Jobs Act signature measures

	2017 Law	Tax Cuts and Jobs Acts 2017	Implications
TOP INDIVIDUAL INCOME TAX RATE	39.6% above \$426,700/\$480,050 for singles/couples	37% above \$500,000/\$600,000 for singles/couples	More take home pay, but some or all may be offset by capped SALT deduction
STANDARD DEDUCTON	\$6,500	\$12,000	Good for those who did not itemize under current law
PERSONAL EXEMPTION	\$4,050 each	Eliminated	Huts families with three or more children
STATE & LOCAL TAX DEDUCTION (SALT)	Income or sales and property taxes	Deduction capped at \$10,000	Negative for high tax states' high income taxpayers
MORTGAGE INTEREST DEDUCTION	Deduct interest on up to \$1M of debt	up to \$750,000 of debt	Slight negative for high-end and more expensive urban markets
CAPITOL GAINS	23.8%	No change	FIFO rule not enacted
ESTATE TAX	40% above \$5.6 million	40% above \$11.2M	The wealthy should accelerate gifting before the \$11.2M exemption expires in 2026
TOP CORPORATE TAX RATE	35%	21%	Domestic high paying firms get a one-time boost to earnings
BUSINESS INTEREST DEDUCTION	Fully deductible	Capped at 30% of EBITDA for 4 yrs., then 30% of EBIT	Hurts highly leveraged companies and potentially a negative for high yield bonds
TAX ON OVERSEAS EARNINGS	Worldwide system with deferral and credit for taxes paid abroad	Modified territorial system	Narrows the gap with foreign tax rates and makes it less appealing to become foreign domiciled
ONE TIME REPUTATION TAX	None	8% on Illiquid Assets; 15.5% for cash	Repatriated cash likely to boost M&A, dividends, and stock buybacks

able two-year work permit and exemption from deportation. Democrats are insisting on an agreement to address the DACA policy before passing a spending bill, while Republicans and the President appear to want to address DACA only in a comprehensive immigration reform context. Given all of the vitriol in Washington, the 2018 midterm elections will be in keen focus for our economy and markets. Based on the drubbing Republicans have

taken at the ballot boxes of late and President Trump's dwindling support among independents, there could be a growing chance of Democrats recapturing the House and even the Senate in November 2018. The momentum could even carry Democrats to winning back the White House in November 2020. Republicans are hoping that the tax cuts will do enough pump priming to help stem the recent tide of losses. For now, though, we must closely

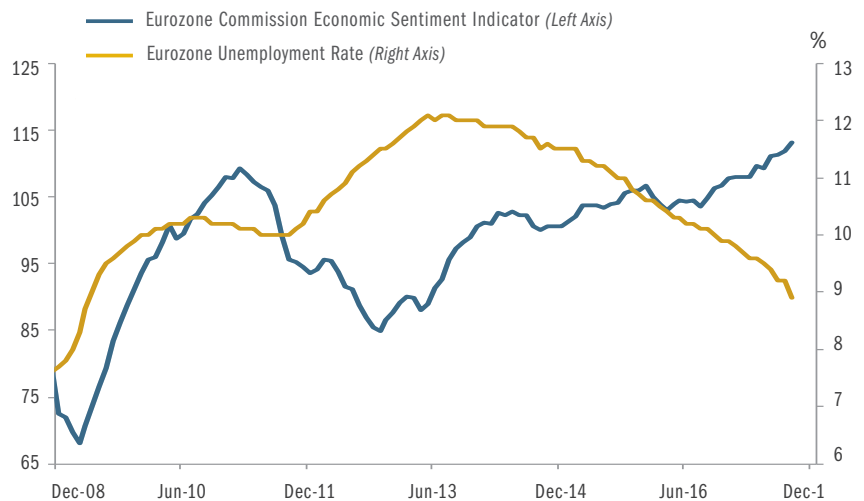
watch the developments in Washington related to immigration and trade, which are likely to reverberate as the future of NAFTA hangs in the balance. Finally, while the war of words between North Korean Supreme Leader Kim Jong-Un and President Donald Trump has subsided for the moment, all eyes will be on Pyeongyang, South Korea for the February 9th start of the Olympic Games as the world watches and hopes for peace.

DEVELOPED INTERNATIONAL ECONOMIES: We Have Lift-Off

THE EUROZONE SURPRISED ON THE UPSIDE IN 2017. The worst-case scenarios of divisive populist political victories were averted, while the economy continued to deliver relatively robust GDP growth. Economic sentiment, which reflects positive economic developments in the region, has reached a decade-plus high and continues to trend higher. With employment 5% higher than it was at the end of 2013, this growth is leading consumers to increase spending on a range of goods and services after years of relative deprivation.

The unemployment rate fell to 8.8% in October, the lowest rate since January 2009. Meanwhile, inflation was 1.5% in November 2017, up from 0.6% in the same month in 2016. Despite progress, unemployment

Europeans positively euphoric and unemployment, while still elevated, remains in steady decline



and underemployment remain elevated and core inflation remains low, suggesting significant runway for further growth. Particularly encouraging in this regard is that domestic consumption and investment have driven growth for the last three years, even while net exports were a drag on growth in six of the last seven quarters. Importantly, while growth had been largely dependent on the stronger core economies in the early years of the recovery, all member states are now in expansion. Notably, Spain's real GDP per capita has almost regained its 2008 levels after declining by over 11% from 2008 to 2013. Italy remains a laggard with real GDP per capita well below its 2008 level.

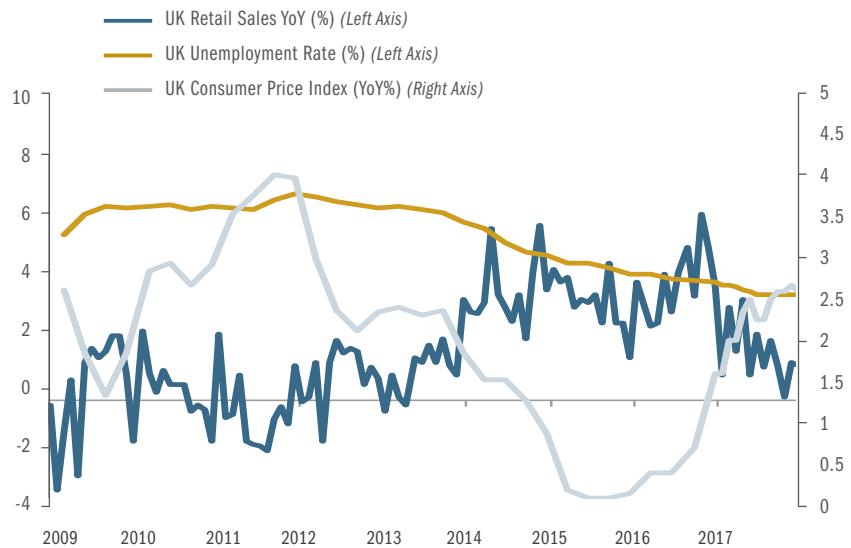
This moderating growth trajectory combined with low, stable inflation will give the ECB ongoing cover to maintain a negative deposit rate well into 2019 and follow through on its plan to maintain a QE program at €30 billion per month until at least September, with the potential for net increases in holdings beyond that date.

Turning to politics, Emmanuel Macron's presidential victory and Chancellor Angela Merkel's September party win lifted an anchor that had weighed down investor confidence in the region entering 2017. Sadly, though, those triumphs were short-lived as Macron's approval ratings dropped by nearly 20% within four months of his election victory, and Merkel failed to form a coalition government with the Social Democrats after her election win. Even more worrisome have been the developments in Catalonia and Northern Italy seeking a separation and more autonomy, reminding us that European politics are anything but settled. Next up is the Italian election on March 4 where multiple candidates are vying for their party's victory, including Luigi Di Maio from the Five Star Movement, disgraced former prime minister Silvio Berlusconi and his Forza Italia (Go Italy!) party, former prime minister Matteo Renzi of the Democratic Party, and centre-right Lega Nord leader Matteo Salvini. Outside of Berlusconi's Forza Italia, all of the other parties are euroskeptic to say the latest, which will throw into question the future of Italy in the EU despite the challenges of an alternative path as we are seeing with Brexit.

On that note, Brexit progress has not accelerated meaningfully in the 17 months since the June 23, 2016 vote. In March of 2017, the United Kingdom invoked Article 50 to begin the up to two-year process of exiting the EU. Any momentum in the initial months after this action hit a speed-bump when the Conservatives gambled on winning an even stronger mandate in par-

liment in June elections, only to be forced to form a coalition with the Democratic Unionist Party to salvage a small governing majority. Since the election, Prime Minister Theresa May has faced a quiet uprising in her own party that has complicated exit negotiations. Looking forward, the current negotiating position of the UK government appears weak and undefined, as the debate has not progressed much beyond the initial terms of divorce.

UK consumer slumping as Brexit uncertainty looms and inflation spikes



liament in June elections, only to be forced to form a coalition with the Democratic Unionist Party to salvage a small governing majority. Since the election, Prime Minister Theresa May has faced a quiet uprising in her own party that has complicated exit negotiations. Looking forward, the current negotiating position of the UK government appears weak and undefined, as the debate has not progressed much beyond the initial terms of divorce.

Despite a sluggish economy, the Bank of England's (BoE) monetary policy committee raised interest rates for the first time since November 2007, from a record low of 0.25% back to 0.50%. Annual consumer price index inflation reached 3.1% in November, breaching the BoE's upper target. The UK budget did little to dispel the fears around a likely UK slowdown as the Office for Budget Responsibility downgraded its 2018 and beyond GDP growth forecasts for the country.

strongest sentiment reading among large manufacturing companies in more than 11 years. The unemployment rate declined to 2.7%, a new low for this cycle, while the number of people employed extended the rising trend seen throughout 2017.

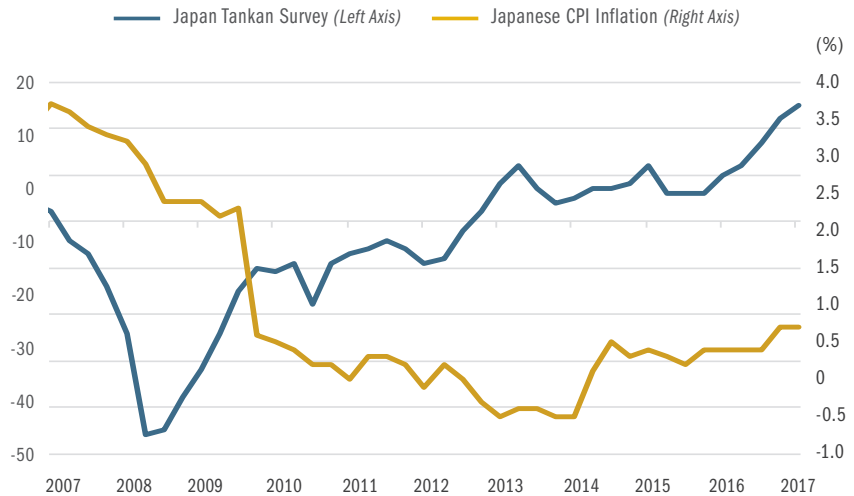
Indeed, the number of active openings per active applicant has increased to 1.5 and scheduled wages for part-time workers are now growing at 3% per annum. Wage growth at small employers has also accelerated through the year as labor shortages have worsened. In recent years, Japan offset part of this pressure through policies to increase the number of women in the workforce. However, at this point, the female labor force participation rate exceeds that of the U.S. for women aged 18–54, leaving less room for improvement. Wage growth is likely to continue to grind higher into 2018 as aging reduces the availability of workers even while increased tourism, domestic

economic activity, and preparations for the 2020 Olympics in Tokyo increase demand for labor.

On the Japanese political front, an October snap election was a great success for Prime Minister Shinzo Abe as the Liberal Democratic Party (LDP) renewed its supermajority in the lower house of parliament. This victory allowed Abe to get back to focusing on policy rather than reelection, with plans for a referendum to codify the legality of having a national self-defense force in place. We are hopeful that Abe will decide to postpone the October 2019 increase in Japan's consumption tax, and find a much less disruptive way to balance public finances, without as negative of an impact as the consumption tax increase made in April 2014. Notably, the U.S. exit from the Trans-Pacific Partnership (TPP) derailed the momentum Abe had built for reforms to satisfy the terms of the treaty, leaving Abe to pursue a charm offense on Trump in hopes of achieving a bilateral trade pact.

In consideration of some of these developments and setbacks, Japan is likely to be in the same situation as it has been in recent years where the burden for stimulat-

Japanese corporate sentiment surges on bright outlook



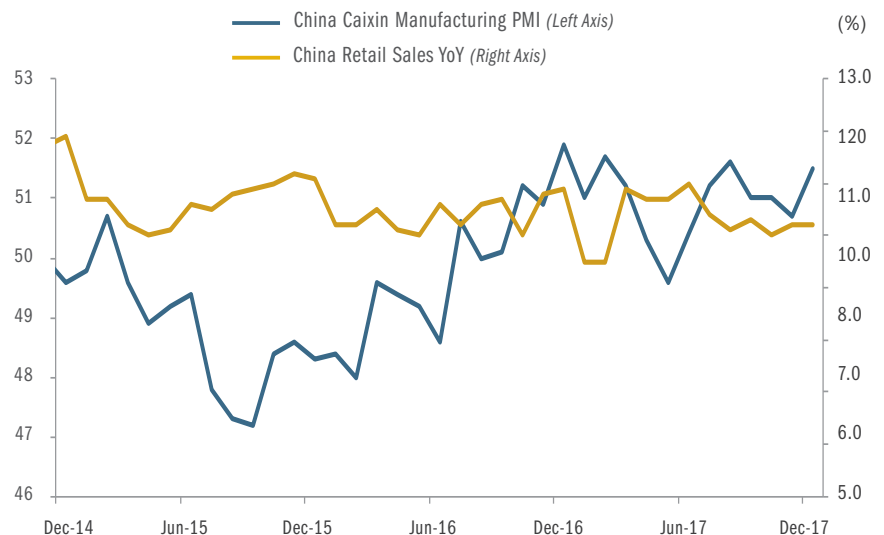
ing growth falls disproportionately on the Bank of Japan and Haruhiko Kuroda. As an aside, Kuroda's term as Governor of the BoJ is set to expire in April 2018, although we expect that he will be reappointed. If this is the case, we expect yield curve control to be sustained with a target of a 0% yield for the 10-year Japanese government bond, even while U.S. and euro zone rates begin nor-

malizing. Kuroda has pledged to forge on with very accommodative monetary policy as the BoJ's inflation target remains distant and a "deflationary mindset" still permeates business activity. Like Abe, Kuroda is committed to pulling Japan out of nearly two decades of economic stagnation and deflation, and remains resolute in that goal.

CHINA & EMERGING ECONOMIES: No Growing Pains

IN 2017, EMERGING MARKET INVESTORS FOCUSED FIRST on the stabilization of Chinese GDP growth and then on the leadership transition into Xi Jinping's second term as General Secretary of the Communist Party of China. The services sector continued to grow at a double-digit nominal pace, while the secondary sectors (manufacturing, utilities, mining, and construction) returned to similar levels of growth. This economic strength was sustained in large part through continued increases in leverage, particularly in the corporate sector. At the same time, China's leadership increased its verbal commitment to supply-side structural reforms (i.e., reducing excess capacity in certain industries such as cement, coal, and steel), reducing environmental degradation, and mitigating risk in the financial system. Thus

Chinese rebalancing of manufacturing and consumer activity shows progress and potential



far, China has sustained current level of GDP growth at its target rate of 6.5%, and we expect more of the same in 2018.

Notably, authorities at the local and provincial level tried to restrain home price speculation and rampant appreciation. Dozens of cities enacted new restrictions on property transactions to require owners to hold the property for anywhere from two-to-ten years before they are allowed to sell. These new restrictions are on top of already relatively conservative loan-to-value limits on mortgages to buy property. And they succeeded to some degree. Out of 70 of the largest cities in China, by September only 13 saw home price appreciation exceeding 10% year-on-year, while 31 saw price increases of 5%–10%, and 24 saw prices increase 0%–5%. Only two cities had prices that declined over the prior year. At the peak in May and June, 31 out of the 70 cities had price increases in excess of 10%. Controlling home prices is a key priority for policy makers in China who have concluded that housing price bubbles that are followed by busts lead to capital outflows. We expect this will be a key priority in the years ahead for both these economic reasons and to mitigate the pressure on young first-time home buyers who are increasingly priced out of the market in major cities.

In October 2017, the delegates at the 19th National Congress of the Chinese Communist Party renewed Xi Jinping’s term as General Secretary of the Communist Party. There was substantial speculation around the Congress about the rest of the Party’s Standing Committee, with a focus on whether historical norms would be followed and potential implications for Xi Jinping’s longevity as China’s leader. While much remains in question, the addition of “Xi Jinping Thought on Socialism with Chinese Characteristics for

a New Era” to the constitution leaves little doubt about Xi’s status, putting him on par with Mao Zedong in the hierarchy of China’s modern leaders. The priorities stated by President Xi included an increased emphasis on environmental standards, “quality growth”, and achieving a “moderately prosperous society,” reinforcing investor expectations that are supportive of ongoing capital inflows and interest.

As for other Asian economies, India’s growth is expected to accelerate further as recent fine-tuning measures on GST compliance, a large recapitalization plan for public banks, and easing policy uncertainty all bolster the economy’s performance. Other emerging countries in Southeast Asia like Indonesia and Thailand are likewise enacting reforms and correcting the fundamental imbalances that have made them vulnerable economies in past financial crises.

Meanwhile, Latin American countries are benefiting from a broad shift toward political leaders with investor-friendly policies and away from populist politicians who have dominated the region more recently. For example, Argentine President Mauricio Macri, elected in 2015, has already made significant progress on meaningful reforms and looks likely to win reelection in 2019. In Brazil, there are signs that the economic recovery is widening and lower interest rates have helped consumer and business confidence. Although continued political corruption scandals have knocked reform momentum in Brazil off course, optimism exists that meaningful structural reforms, especially related to public pensions, will be in focus in 2018. That said, unpopular incumbent Michel Temer faces an uphill battle to win October’s presidential election, with scandal-scarred former

President Lula da Silva making a case of his own. As for Mexico, the country faces the twin risks of the U.S. renegotiating NAFTA and a potential victory for leftist candidate Andrés Manuel López Obrador in their July 2018 presidential election.

Turning to other emerging market notables, Russia and Turkey have been key laggards in the emerging market recovery story. However, Russia enjoyed impressive domestic demand-led growth in 2017, and their central bank has room to cut interest rates amid moderate inflation, which could bode well for growth going forward. On the other hand, Turkey continues to have a tough outlook, with double-digit inflation amid steamy growth and an unstable lira. Finally, strong growth in the Central European emerging markets of Poland, Hungary and the Czech Republic is likely to persist as an expected broadening in the eurozone economic recovery should continue to be beneficial.

**GLOBAL MARKET OUTLOOK:
Simply Epic**

GLOBAL EQUITIES DELIVERED POWERFUL and consistent returns in 2017, shaking off natural disasters, populist uprisings, a nuclear threat, and an ongoing stream of fodder for what once would have been Presidential scandals, but now pass for business as usual in the Trump administration. Both the MSCI World and S&P 500 indices posted positive gains in all 12 months of the year, a rare feat, and market volatility sunk to its lowest level in a generation.

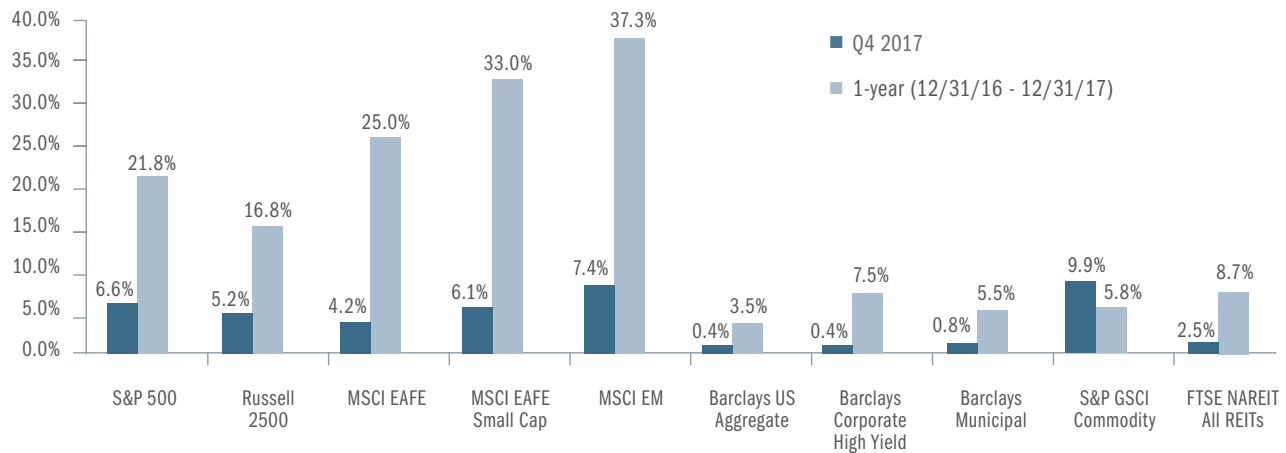
The rally in U.S. equities, founded on solid economic data and buoyed by optimism around a pro-growth platform as promised by the Republicans in the White House and Congress, continued essentially unabated. Indeed, the S&P 500 closed up over +20% for 2017, and while U.S. small caps lagged behind with only a 16.8% return for the Russell 2500, a slowing could only be expected after the segment’s meteoric rise in 2016 in the wake of Trump’s election.

International developed stocks posted a strong year after consistent underperformance when compared with U.S. stocks following Europe’s sovereign debt crisis. European stocks led the way higher

Summary of Latin America country policy adjustments in the works that defy populism

	Argentina	Brazil	Columbia	Venezuela
Price deregulation	X	X		
FX deregulation	X			
Fiscal consolidation	X	X	X	
Strengthening Institutions	X	X	X	

Fourth quarter and 2017 market returns defy gravity in most market segments



in 2017, spurred by economic strength and continued accommodation from the European Central Bank. Small cap stocks, which had been the bright spot for international developed markets the last several years, once again outperformed large caps, and while growth outperformed value, the spread was narrower than that experienced in the U.S. Emerging markets stocks, which had suffered under fears of a Chinese debt bubble and the sharp drop in oil prices, enjoyed a weaker U.S. dollar and global growth in 2017, earning the benchmark a whopping +37% gain for the year.

Perhaps the most notable trend in 2017 was the dramatic swing in style leadership. For the third straight year, global markets were led by a completely different cohort of stocks than in the previous year. In 2015, low-volatility stocks did best. In 2016, value stocks were the strongest performers. And last year, it was all about growth. The popularity of growth stocks is being driven partly by the explosive potential of new Internet and media dynamos. In the U.S., Facebook, Amazon and the three other so-called FAANG stocks were so popular that they accounted for almost a fifth of S&P 500 Index returns. Similarly, in emerging markets, Chinese Internet powerhouses Alibaba.com and Tencent fueled much of the market's gain.

Within fixed income markets, despite fears of Fed tightening and a tough backdrop for bonds, most U.S. bond indexes closed the

Growth stocks dominate in 2017

2015	2016	2017
MSCI World MAXIMUM VOLATILITY 7.4%	MSCI World VALUE 14.2%	MSCI World GROWTH 24.0%
MSCI World GROWTH 6.1%	MSCI World MAXIMUM VOLATILITY 7.7%	MSCI World MAXIMUM VOLATILITY 15.1%
MSCI World VALUE (-1.9%)	MSCI World GROWTH 4.0%	MSCI World VALUE 13.3%

year higher. While many expected yields to march towards the 3% mark during the course of the year, the 10-year Treasury yield actually fell all the way to 2.04%, and only hit a high of 2.62%, eventually closing at 2.41%—essentially right back where it started. Credit outperformed government bonds for the year, as strong corporate results and positive economic data kept spreads tight. Municipals also closed the year higher, despite concerns around tax changes and specific issuer credit concerns. In both the corporate and municipal markets, risk reigned supreme, as high yield outperformed investment grade once again.

Commodities closed higher on the year, led by gains in crude oil, with WTI up +12.5%. Precious metals and copper also posted gains, while agricultural commodities were mixed. The U.S. dollar, which was expected by most forecasters to rise in 2017, closed down -9.8%, its biggest decline versus a basket of currencies in 15 years.

And finally, we would be remiss not to comment on the hyperbolic rise in the value of bitcoin in 2017, which drew the attention of the public and investors, as well as regulators, during the year. As a reminder, bitcoin is the first decentralized digital currency; it is not run or managed by a central bank, and therefore cannot be devalued like fiat currencies. In 2017, the Chicago Board Options Exchange (CBOE) and the Chicago Mercantile Exchange (CME) both launched bitcoin futures as demand from traditional investors has risen. Prices for the cryptocurrency soared from less than \$1,000 in January 2017 to \$17,000 to end the year. Whether it finally becomes a mainstream asset or not is still up for debate, but we doubt it will be disappearing any time soon.

Tax reform euphoria helps U.S. stocks extend their streak

U.S. equities have had a great year, remarkable not only for their strong returns, but also for their consistency and lack of volatility. U.S. equities delivered positive returns

in every single month of 2017, the first time this has happened since 1958. On average, U.S. equities experience an intra-year draw-down of about 14%. In 2017, the maximum drawdown for the index was less than 3%. Over 2017, tech stocks rose by close to 40%, but the market rally was relatively broad based, with consumer discretionary, materials, industrials, healthcare and financials all returning about 20%. However, defensive bond-proxy sectors such as utilities, telecommunications and real estate investment trusts lagged over both the year and the quarter. The reduction in the corporate tax rate to 21% will boost after-tax earnings for U.S. companies in 2018, but has already contributed to the strong returns for U.S. equities in 2017. It was not just tax-cut expectations driving U.S. equities higher though; third-quarter S&P 500 earnings per share rose by 6% year-over-year.

Small caps underperformed large and mid-cap stocks on the year—despite a nice boost in the back half from tax reform — and the marked outperformance of growth over value stocks extended across the capitalization range.

Japanese equities lead the charge in developed international markets

Despite a good year for the European economy, corporate earnings (up 10% year on year in the third quarter) and equity returns, European equities have underperformed several other markets in local currency terms. European equities had a great start to the year, as business surveys picked up and political risk faded with Emmanuel Macron’s election. The strong rally in the euro in the first three quarters of the year explains much of the subsequent drag, since May, on European equities in local currency terms. Foreign revenues have had to be translated at a less favorable rate. In the fourth quarter, European equities delivered the lowest returns, despite a broadly flat euro. Furthermore, politics has given European investors reason to pause for breath, with the Catalan independence referendum in October weighing on the relative performance of Spanish equities since August. Since the start of October, Italian equities have also given up a little of their outperformance for the year as investors start to look ahead to the

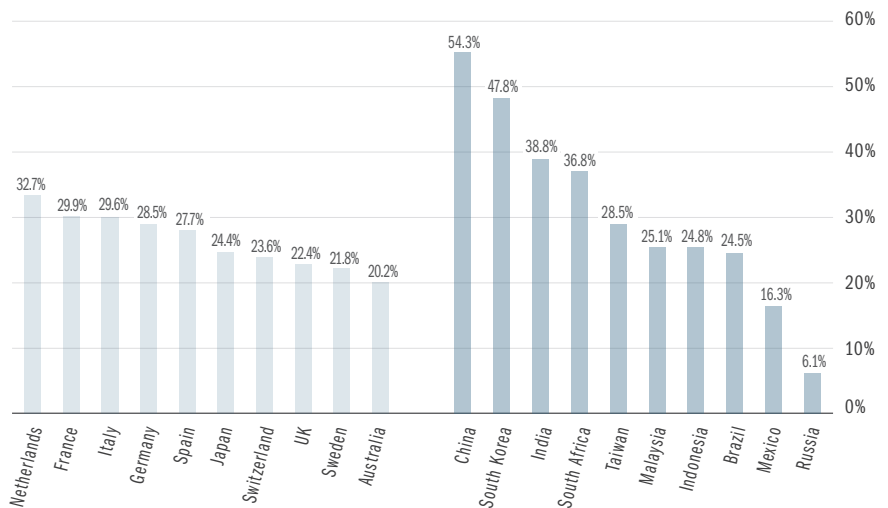
Italian elections next year, although it should be noted that they have still delivered some of the strongest returns this year, up 30%.

Japanese equities also had a very strong quarter and year. The major driver of Japanese equities this year has been the fantastic performance of company earnings, which rose by 16% year-over-year in the third quarter. Earnings were bolstered by strong global growth and a pick-up in global trade. Prime Minister Shinzo Abe comfortably won the election in October, providing political stability and boosting confidence that there should be few changes to his economic policies, especially assuming Kuroda remains at the helm of the BoJ.

As for sector returns for the MSCI EAFE index, healthcare, telecoms and financials sectors underperformed, while materials was the top gainer. Industrial metal prices rallied against the generally favorable backdrop for global and Chinese demand in particular. Mining companies performed very well as a result. The oil and gas sector also outperformed over the period as crude oil prices were supported after OPEC-led production cuts were extended until the end of 2018. In addition, the oil majors delivered strong third-quarter results, underpinned by ongoing cost and capital expenditure discipline. This added to market confidence that their dividends will be covered by cash flows, even at spot crude oil prices signifi-

Stunning returns delivered by international and emerging market countries of all shapes and sizes

2017 Country Performance



UK equities underperformed most other regions this year, due mostly to uncertainty over Brexit negotiations. Investors have also had to contend with the strength in the pound sterling in 2017, weighing on the value of foreign revenues, which make up close to 70% of FTSE 100 sales. The more domestically focused mid-and small-cap stocks have therefore outperformed in 2017, although performance relative to the FTSE 100 was broadly flat over the most recent quarter. The deterioration in UK consumer confidence stands in contrast to the buoyant consumer confidence seen in most other regions.

cantly lower than the current level. Within healthcare, some corporate updates disappointed the market, including below-consensus Q3 revenues from pharmaceutical giant Sanofi.

Emerging markets equities have a tiger in their tank

The best-performing equity markets this year have been in Asia and the emerging markets. A weak dollar has historically been supportive of the relative performance of emerging market equities and this proved to be the case in 2017. EM equities also benefited from a rebound in earnings

off of a low base. Furthermore, the rally in tech stocks supported EM, which started the year with about 25% of the MSCI index made up of tech names. In addition, the recovery in some industrial commodity prices, such as copper, has also supported some of the more commodity-focused EM stock markets.

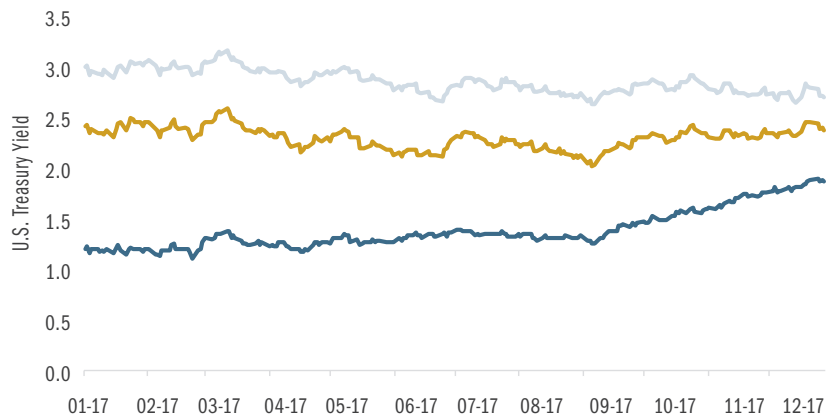
The Asian markets and China in particular benefitted as the 19th National Congress of the Communist Party laid out a plan for reducing financial risks while focusing on delivering slightly lower, but still very substantial, GDP growth. South Africa was another strong market as pro-reform candidate, Cyril Ramaphosa, was elected leader of the African National Congress. This development increased the prospect for a return to more orthodox policy after elections in 2019. Greek equities also rallied as the country reached agreement with international creditors over reforms, paving the way for the dispersal of further bailout funds. Thai stocks surged, supported by upbeat GDP numbers. India stocks gained as the government announced plans for a major recapitalization for state-controlled banks. Meanwhile, South Korea benefited from China's effort to reset relations, which had deteriorated after South Korea proceeded with full THAAD missile deployment.

In contrast, Mexico posted a negative return in the quarter and was one of the weakest countries in the index for the year. This was largely attributable to peso weakness, amid concern that negotiations to modernize NAFTA may collapse. Brazil also posted a negative return in the quarter as a result of currency weakness. Notably, Congress voted not to send corruption allegations against President Temer to the Supreme Court in October. Russia struggled to get out of first gear as economic sanctions and the Russia investigation cast a cloud over a robust recovery in commodity prices.

Bonds hang in there despite rising rates, with munis and emerging debt in the lead again

U.S. Treasury yields rose over the quarter, and the yield curve flattened, thanks to the U.S. tax reform bill which is expected

The yield curve flattens dramatically in 2017



to stimulate growth and inflation. For the quarter overall, 10-year U.S. Treasury yields increased from 2.33% to 2.41%, five-year yields rose from 1.93% to 2.21% and two-year yields from 1.48% to 1.89%. The additional yield offered by the 10-year Treasury note compared with the two-year note shrank from 86 basis points to 51 basis points by the end of December, its lowest level since 2007. While this curve flattening has many possible explanations, investors would do well to respect that the yield curve has proven a reliable indicator of impending economic slumps when it inverts, and short rates exceed longer-term yields.

Credit spreads continued to tighten on both investment grade and high yield bonds, reaching their narrowest level since 2007. The below investment-grade sector was supported by investor demand for higher yields, a strong equity market, and a backdrop of solid credit fundamentals with minimal defaults. Moreover, rising oil prices helped issuers in the high yield energy sector, and shrinking net supply in the market, driven by bonds maturing or being redeemed in refinancing deals, also fueled demand.

Mortgage-backed securities (MBS) produced modest results for the quarter but outperformed Treasuries. The Fed began reducing its MBS holdings, but higher interest rates reduced mortgage prepayment risk and were a tailwind for the sector.

Despite a record-setting US\$62.5 billion of new issuance in December, the munic-

ipal bond market was supported by solid demand and outperformed U.S. taxable investment-grade bonds for the quarter. There were concerns that the new tax law would eliminate the tax exemption on advance refunding bonds, which are issued to retire old debt, and private activity bonds, which are often used to fund projects such as hospitals and airports. Although the status of private activity bonds wasn't changed in the final version of the bill, issuers moved many deals that had been planned for early 2018 to the end of 2017 to protect the tax exemption.

Finally, emerging markets bonds were supported by solid demand. Brazil's central bank cut its short-term benchmark rate by a total of 1.25% during the quarter to a record low 7% and signaled that another smaller cut may be coming in February if inflation continues to decelerate. In China, bond yields climbed to their highest levels in three years as the government cracked down on speculative financial activities following October's Communist Party Congress.

Commodities stage a comeback

The Bloomberg Commodities index posted a robust return in Q4 of +4.7%, underpinned by a rally in industrial metals and energy. In industrial metals, nickel (+22%) and copper (+12%) and iron ore (+12%) posted the strongest gains as Chinese demand remained firm. Together with measures aimed at lowering environmental emissions, which have led to

an increase in supply discipline, this put upward pressure on prices. In the energy segment, Brent crude surged +18.2%, primarily driven by an agreement among OPEC, and a number of non-member countries such as Russia, to extend production cuts to the end of 2018.

As for the future in this volatile segment, we see capex discipline and China's supply-side reforms propping metals prices in 2018. The rise of electric vehicles (EVs) has brightened prospects for copper as well as for niche commodities such as lithium, cobalt and graphite. Rapid EV adoption may reduce oil demand in time, but an easing in the supply glut and geopolitical risks should put a floor under prices in the short term. These dynamics are likely to stick in 2018, but we see returns moderating as prices have risen.

Looking ahead

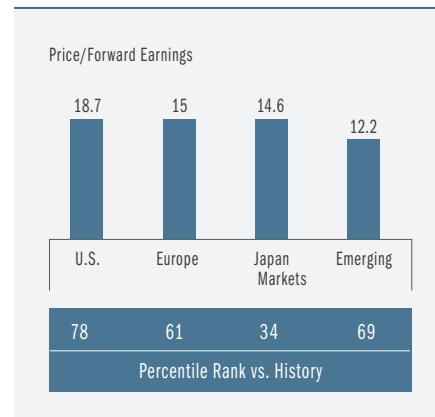
Will 2018 be as good? Possibly, as many of the fundamental drivers of strong stock market returns—synchronized global growth, rising corporate earnings, low interest rates and inflation—remain in place. Of course, the economy is not the only variable that drives investment decisions and asset prices. When allocating capital, investors have to consider a range of factors, which also include valuation, liquidity, and sentiment. Financial assets, in general, are not cheap relative to history or in absolute terms. It is unlikely that a continued upward path will be as smooth, and the best areas to be invested in are likely to be different than in 2017. We suspect security selection will be critical to generating returns in the years ahead, as global growth normalizes and the “easy money” of the market rallies in recent years is harder to come by.

For all of these reasons, we recommend maintaining an appropriate balance of equities and fixed income, and see no reason to extend or limit allocations aggressively in any one specific direction. Stocks are still very attractive versus bonds and many investors cannot afford to give up the return potential

of equities. What's more, stock correlations have declined in recent months, which tend to create better conditions for stock pickers to generate alpha. Indeed, opportunities exist beneath the surface, as there are still big differences between regions, sectors, industries and, of course, individual companies.

Within U.S. equities, our portfolios remain positioned to take advantage of both deflation and rising rates, with a nod towards the potential positive benefits of tax reform. We favor more cyclical parts of the market with concentrated managers that focus on technology, energy, financial, and select industrial names. We also favor large caps over small caps, given the later stage of this economic cycle. That said, small and mid-sized U.S. companies are surely the biggest beneficiary of tax reform

Regional valuation differences demand diversification



and for now remain a market segment we have tilted towards.

As in 2017, we are positive on more domestically focused, small international developed equities going into 2018, even with strong gains posted last year. We are constructive on emerging markets equities as well, as the global growth trend, a stable U.S. dollar, and steadied commodity prices all point towards the potential for strong returns in these markets.

Within fixed income, we think it is best to be defensive in short- and intermediate-maturity bonds that are more credit than interest-rate sensitive, and see oppor-

tunity in municipal bonds for taxable investors in some of the market disarray left by tax reform. We also continue to seek differentiated fixed income returns through the use of convertible bonds, high yield, and flexible fixed income allocations.

At the same time, investors can't afford to ignore the risks. Perhaps most importantly, while growth trends are encouraging, inflation is a wild card. If labor market conditions in the U.S. tighten or global economic growth accelerates, inflationary pressures could emerge. And if this prompts a sharper rise in interest rates than investors now anticipate, equities could suffer: multiples could take a hit as investors use a higher rate to discount future earnings and fears of recession rise.

Concerns of a slowdown could also emanate from China, where growth might decelerate more rapidly than expected. Another true test of global health will be how economies adjust to less central bank stimulus after nearly a decade of priming the pump in favor of asset prices. Finally, political risk is real, from U.S. tensions with North Korea to Brexit.

And financial markets may generate their own surprises: we see some risks in the popularity with investors of potentially risky bank loans, for example, not to mention the explosion of interest in crypto-currencies. Currency is also a potential source of risk; if expectations of a rapid acceleration of U.S. economic growth, driven by tax cuts, prompt a strengthening of the U.S. dollar, emerging markets would be particularly vulnerable. Finally, passive strategies, which now account for 60% of equity assets, up from less than 30% a decade ago, may be causing market distortions in ways that we have yet to quantify.

Yet we still believe that the bull has room to run as domestic economic strength is improving and global economies look better than they have in some time. We believe investors should stay disciplined, diversified and invested, as one of the greatest risks of an aging economic and market cycle can be cashing out too soon.

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