ViewPoint

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Looking Back to Move Forward

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Markets delivered solid returns for both equity and fixed income investors in 2017. Our clients' modeled portfolios strongly outperformed, and as a bonus, markets exhibited record-low volatility.

We certainly had a lot to be thankful for this holiday season but also know that our most difficult work still lies ahead. Trust Point's investment committee recently sat down to recap 2017 and discussed the outlook for 2018 and beyond. We were once again reminded that a simple principle still holds true; when an investor owns a portfolio that is different than the market, only then can they expect a different outcome. This was important for our clients in 2017 and will be even more important in 2018.

More highlights from our conversation:

International equity exposure: Our research led us to the reward!

Coming into 2017, many investors were fearful of international equity markets. Ongoing concerns over China and the busy upcoming political calendar in Europe caused investors to stay away. International markets had chronically underperformed for nearly a decade, and our clients often asked us why they should own any in the first place. We believed the populist parties in the Netherlands and France would not take over in 2017, European growth would be an upside surprise, and the global economy would strive with China's economy remaining resilient. Our view was very different than most investors and our clients' were rewarded for it. International stocks performed strongly in 2017 and were keys to the outperformance.

Credit fixed income exposure: Finding opportunities in a low interest-rate environment

Owning a portfolio that is different than the market can require a contrarian position, as the example above illustrates. At times, it may also mean having exposure to certain segments or sub-asset classes not represented or under-represented in major market indices. For example, in the fixed income component of client portfolios, we have preferred credit risk over interest rate risk throughout 2017. Our view indicated senior bank loans, high yield debt, and convertible debt would benefit from solid corporate profitability, low defaults, and attractive yields. Our bullish view on these sub-asset classes paid off as those were also important contributors to outperformance for our clients in 2017.

2018+ outlook for equities: Positive

We have been overweight equities relative to bonds all year, which has also contributed to outperformance for our clients. Despite strong gains in equity markets as of late, we remain comfortable with our overweight allocation. In the past 12-18 months, the economic expansion has become increasingly broad-based across sectors and geographies, both domestically and globally, increasing our confidence. Supported by strong economic growth (and therefore earnings growth), equity prices are well supported despite some legitimate concerns over valuations (especially in the U.S.). Led by international stocks where valuations are notably lower, equities could still do quite well in 2018, but there may be increased volatility. A sustained bear market in equities would require a recession, which our indicators say is unlikely in the next 6-12 months.

2018+ outlook for fixed income: Not as positive

Most of our clients think we are paid to make money. We see ourselves more as being paid to worry! Arguably, the best way to make money long-term is not to lose too much short-term. What currently keeps us awake at night? Bonds.

In 2017, inflation fell, and longer-term bond yields fell with it. This helped boost bond prices even as the economy improved. However, strong growth and low inflation don't typically cohabitate for very long, especially at the late stage of an economic cycle. What worries us is that price pressures continue to intensify in many forward-looking inflation indicators of the U.S. economy (chart 1).

As a result, and against a background of low yields and tight valuations, we believe that bond prices will be pressured lower in 2018 as U.S. inflation surprises on the upside. Our analysis shows that the bond market has not fully anticipated that potential outcome. In 2018, we expect the 10-yr Treasury yield (currently below 2.5%) to push 3.0%. Aside from inflation, a possible shift in tone at the European Central Bank may put upward pressure on global yields as well. At higher yield levels, we would consider interest-rate-sensitive bonds to be more attractively valued, but for now, we remain cautious by underweighting duration (sensitivity of a bond portfolio to movement in interest rates) and by minimizing our exposure to interest-rate sensitive bonds like Treasuries, Agencies or other foreign government bonds in portfolios. For fixed income investors, casting a wider net and thinking outside the box will be critical in positioning fixed income assets in 2018. Our clients' modeled portfolios are well prepared for a rising interest rate environment.

Newsflash: GOP tax bill is now the law

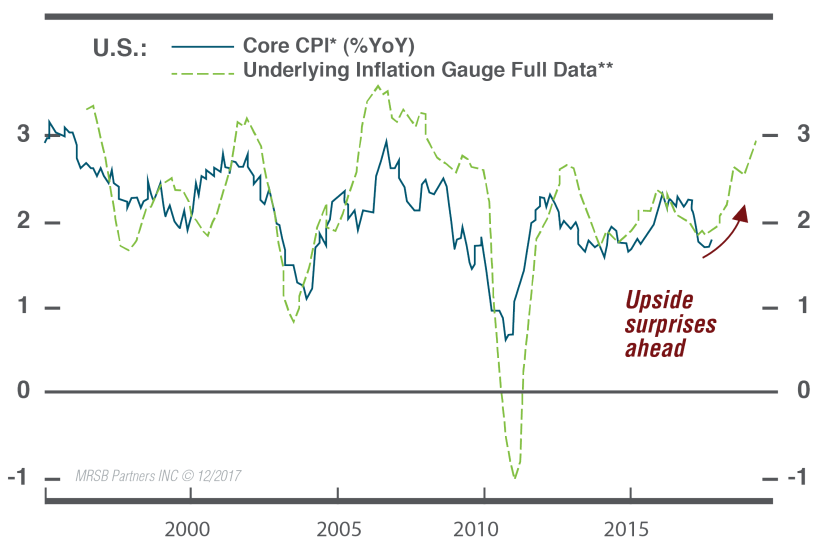
Good news for investors. In the recently approved tax bill the preferential tax rates on long-term capital gains remain unchanged. That is good news since sizable appreciation in asset values in recent years has led to higher taxable capital gain distributions from mutual funds this year. In recent weeks, wherever possible, we have used opportunities in accounts to harvest some losses or re-allocate assets between funds before large capital gain distributions to minimize the tax consequences for our clients.

We are very thankful for the trust and confidence you have in us.

Happy New Year!

Chart 1

Intensifying Inflationary Pressures in the U.S. Economy



* Excludes food and energy

** Advanced 18 months: includes prices, activity, and financial data:

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