The following outlook provides our investment thoughts for the coming year. We did not include specific recommended asset allocation weightings for the major asset classes, as they will be part of Real Investment Advice premium services. **If you would like to receive pre-launch information on our new services just send us your** email address.

Market Fundamentals

The confluence of improving synchronous economic global growth and hyper-inflating asset markets is urging central bankers to pause extraordinary policies and, in many cases, begin reversing them. While not obvious to most, monetary policy error has been in play since quantitative easing commenced in 2009, but the consequences will not appear until future central bank actions to raise interest rates and reduce their balance sheets affects commerce. The yield curve, credit spreads, and financial conditions can provide indications of when this may occur.

Market Fundamentals Commentary

Record highs in stocks, near-record lows in bond yields and historically tight credit spreads present significant challenges for investors. Economic data has improved, but many fundamental economic gauges remain soft relative to pre-crisis averages and inconsistent with asset price levels and valuations. Most investors do not seem at all concerned as money continues to move into risky asset classes, a classic sign of a bubble. **While a defensive posture seems prudent, the technical picture remains supportive of further gains.** One should respect the momentum behind these moves for the foreseeable future but be mindful that liquidity can evaporate quickly. The primary investment theme remains ?*buy the dip.?* That approach has worked amazingly well, a testament to the sustained strength of markets. Thanks in no small part to gradualism from the Fed on interest rate and balance sheet normalization, the blind assumption is that the favorable trajectory of risk assets can be endlessly extrapolated into the future. There is a distinct difference between taking a defensive posture and a negative one. Remaining full-bore aggressively long at this juncture is a speculative endeavor akin to letting our kids play in the median of a busy highway. Proper care and stewardship of wealth means being protective and forward-looking to avoid large losses.

> *?The peer pressure and career risk of bolstering one's defenses in a Pamplona-style bull run are palatable, but wealth is most effectively compounded by avoiding large losses not chasing returns with the irrationally exuberant. Many investors and others are stumbling confidently forward playing the role of the genius in a bull market. The prudent manager worries about the trifles of liquidity at a time when it is so plentiful it seems unreasonable to worry. Liquidity comes at a cost, but excess liquidity in times of crisis offers both priceless protection and clear-headed decision-making opportunities that are rare indeed.?* ?Liquidity Defined 12/14/2017 ?The Unseen

Outlier scenario - The market is far more sensitive to changes in interest rates than currently perceived. If the Fed continues to increase the Fed Funds rate and reduce their balance sheet in response to low unemployment and moderate levels of inflation, economic activity will decline. The result is a recession that initiates the unwinding of leverage accumulated in the system compounded by and revealing many layers of hidden risks.

Federal Reserve Outlook

The Fed gets new leadership early in the year in Jerome Powell, but he appears to be using the same playbook as Janet Yellen.

- *Yield curve flattening*
- *Financial conditions will eventually become less favorable*
- *U.S. dollar stable at the low end of a 3-year range and supportive of future Fed policy*

Federal Reserve Commentary

Given his time as a Fed board member and non-controversial positions on policy, Fed Chair nominee Jerome Powell should have no trouble being confirmed. He echoes many of Janet Yellen?s perspectives, and his demonstrated comportment is similar to that of the post-GFC era Chairmen. In the near-term, such a status quo transition is constructive for risk markets. However, the lengthy duration of the current economic cycle and the lofty valuations present when Powell assumes command make it hard to argue that the current environment is stable. **Outlier scenario** - The inability of the Fed to effectively respond to a weaker economy due to elevated levels of inflation and/or a dramatically weaker U.S. dollar alters market expectations about the Fed *?put?* that has been in place for the past 30 years.

Bond Markets

Yield curve flatter as Fed interest rate hikes continue but inflation remains tame/below target

- *Debt levels continue to weigh on economic growth and inflation dynamics*
- *Growing debt due to fiscal policy/tax cuts heightens concerns*
- *Shortage of quality collateral and rate differential keeps long-term interest rates low*

Bond Markets Commentary

U.S. Treasury yields are bi-polar. Short maturity yields are rising with Fed rate hikes while long-maturity yields are stable to lower. This dynamic produces a flattening of the yield curve revealing short-term optimism and long-term doubt. On an absolute basis, yields remain very low. The 2-year Treasury yield is 1.82% while the 10-year yield is 2.40%. The 2s-10s yield curve spread resides at the lowest level (0.58%) since the financial crisis of 2008. Investors looking for income in the safety of the Treasury market will die of thirst long before achieving their targets. Accordingly, many investors are reaching for additional yield in riskier categories, namely high yield credit and dividend-paying stocks. This game has been going on for a long time. Despite the relative yield enhancement those alternatives offer, the question of whether or not an investor is appropriately rewarded for taking that risk still exists. Non-investment grad*e, or ?junk?* bond, yields range from 4% to 10%, depending on the company and sector, with the overall average yield at about 5.75%. A bond is relegated to junk status precisely because of the elevated risk of default. At current market yields, junk bonds pose an inordinate threat of record low recovery value and terminal realized yield. **Using the average yield for junk bonds of 5.75%, an average default rate of 5% and a generous recovery rate of 50%, a high yield debt portfolio is mathematically identical to a risk-free asset with a yield of 3.25%.** That amounts to a risk-adjusted premium of only 0.85% over 10-year Treasuries (3.25 - 2.40). A yield pickup of less than 1% is hardly compelling, especially when one considers the downside from current valuation levels is immense. Investors who think they get a nice yield boost from owning high yield debt are not considering the risk-adjusted outcomes. The risk-adjusted premium over Treasuries should be at least 200 to 300 basis points. Fixed income portfolio allocations should reside predominantly in the defensive havens of high-quality sovereign, well selected municipal and investment-grade corporate bonds. We recommend no allocation to junk. **Outlier scenario** ? Rising debt levels, inflation and global concerns over future monetary policy causes interest rates to rise as marginal buyers (Japan, China, Saudi Arabia, etc.) turn to sellers to reduce U.S. debt and U.S. dollar exposure. A disorderly rise in interest rates creates sudden distress and defaults in credit markets.

Stock markets

Markets remain supported as financial conditions are historically ultra-easy, despite the recent interest rate hikes

- *Valuations are stretched to extremes*
- *Investors are conditioned to such valuations and insensitive to history*
- *Momentum and lack of viable investment options helps the market retain a bid*
- *Problems emerge when higher short-term rates have a constricting economic effect*

Stock Market Commentary

There are several measures used to justify current valuations, but they sound similar to those used in the dot-com Tech bubble. The relationships between valuation and fundamentals, on which cash flows are ultimately based, are grossly dislocated. Markets may well move higher, but to advocate a full allocation to equities under current circumstances ignores warnings of bubbles past. Stock market cap-to-GDP, price-to-sales, margin balances, cyclically-adjusted price-to-earnings ratios (CAPE), and others argue convincingly that the stock market is either near historic valuations or well through them. Owning well-selected, single-name companies because they are fundamentally cheap, not relatively cheap, makes sense. Otherwise, limiting general equity allocation exposures is prudent until reasonable opportunities return. We suggest setting stop losses and/or options strategies to help limit downside risk and retain any additional upside. **Outlier scenario** ? Realization and acknowledgment that valuations are high and concern over future returns sparks initial selling as the market begins to collapse under its own weight. This sets off a broad exodus out of risky assets for similar reasons.

FX

Currencies remain the pressure release valve for money printing and monetary malfeasance.

- *GBP at risk to weaken further as Brexit talks continue to languish*
- *Growth in Europe, slow policy response by ECB and political turmoil in Germany point to a weaker Euro*
- *US dollar stable/stronger in response to GBP and EUR*

FX Commentary

The precedent set since the financial crisis suggests one wants to steer away from currencies likely to be devalued for purposes of supporting and manipulating asset prices. The problem with that plan is that all developed world economies are guilty of money-printing schemes. Further, it seems inevitable that they will most likely take this short cut once again should problems re-emerge. The most dominant and liquid currencies are those most susceptible to active and intentional devaluation. Europe?s banking system, though improving, still has significant exposures to possible defaults and therefore the potential for bank failures and government bailouts. Australia and Canada have rather large housing market bubbles that probably will not escape punishment in the next downturn. China remains both a communist regime and a pretender on the stage of free markets. The United States has somehow developed a sick pride in unconventional monetary policies and, given the U.S. dollar?s reserve currency status, will be called upon to conjure liquidity in times of distress. Given that the safest currencies tend to reside in stable nations with strong economies, it is not difficult to see why the U.S. dollar has historically been a safe-haven currency. While muscle-memory argues that the dollar retains safe-haven status in the next crisis, other factors may come in to play and upend much of what has historically held true. Other durable alternatives include the Singapore dollar, the Norwegian krone and the Polish zloty. Finally, the immutable status of gold as money is indisputable, despite decades of efforts from central bankers to discredit its durability. Warren Buffet was wrong to classify gold as an asset as it is the ultimate alternate currency. Given the proclivity of central bankers to print digital dollars, insurance in the form of gold and gold miners warrants consideration in a portfolio. The Bitcoin hype is a speculative phenomenon but one well-timed as it further reflects the lack of trust in central bankers. We do not consider Bitcoin or any other crypto-currency as a replacement for gold, but we are not averse to reasonable alternatives to traditional fiat currencies. **Outlier scenario** ? The Federal Reserve?s willingness to print money to bailout banks following the last financial crisis raises concerns going forward about U.S. dollar stability. Those reservations cause traditional sponsors of the U.S. dollar financed economy (China, Japan, Saudi Arabia) to reduce their dollar holdings thus inciting volatility and resulting in a precipitous decline in the world?s reserve currency.

Commodities

Comparative weakness in commodities and strength in equities is signaling a rare long-term buying opportunity.

- *Gold, crude oil, and copper among other key hard and soft commodities that have been relatively cheap for some time*
- *Natural resources not only reflect value but act as a sound hedge against central bank interventionism*
- *China?s debt growth, excess capacity, and property bubble raise concerns, putting pressure on Australia, Latin America, and Near-term commodity upside limited*

Commodities Commentary

The extent to which crude oil and energy companies have languished since the 2014 peak in crude prices suggests there are opportunities in the stocks and/or bonds of those companies. That said, there is no way around doing the appropriate work to find those opportunities. Energy-related Exchange-Traded Funds (ETFs) tend to include a lot of speculative companies unfit for a defensive stance, which makes it difficult to take a generalized ETF approach. If the Fed does what they do best (print money), then natural resource companies now trading at a relative discount to other sectors of the economy stand to be terrific value plays into the future. There is certainly a risk, but the downside should be limited for the equities and bonds of good, undervalued companies. Broadly, commodities are currently at a unique value point relative to stocks. A portfolio allocation overweight in resource companies may present some volatility but should be a good long-term position to have and add to as the economic cycle progresses. Further, commodities provide a hedge against inflation. While not on the horizon, inflation could force central banks to halt money printing policies with severe effects for asset markets driven by those same policies. Investments in the resource/commodity sector can take the form of good equity selections or, even better, discounted bonds of companies offering above average yields to reinforce durable contracted cash flow returns. **Outlier scenario** ? Similar to gold, in the event of a suddenly unfolding crisis, the demand for natural resources surges as uncertainty about financial assets and central bank responses cause many to use hard and soft commodities as an alternative source of safe haven.

Emerging Markets (EM)

Dependent on trade-based commerce, EMs benefiting from synchronous global growth.

- *Durability of export-led growth key to outlook*
- *EM countries are hurt by US dollar strength*
- *Rising short-term interest rates in the US and issues emanating from China will begin to expose a variety of EM imbalances*

Emerging Markets Commentary:

Emerging market economies tend to be inherently volatile, unstable and marred by crises. Although those risks remain in play, select emerging market countries may offer comparative stability and excellent return opportunities in the next year. An improving trend in emerging market performance fully developed in 2017, and a continuation of this trend has sound historical precedence. That said, there is still plenty of risk and uncertainty especially within the context of a broad global destabilization. A portfolio allocation to EM stocks through funds tracking the MSCI Emerging Markets Index should offer a return boost if we are to have another year of low volatility. On the other hand, if 2018 proves to be turbulent, this exposure will certainly detract from returns. Dollar strength tends to play a big role in EM returns. Any sustained U.S. dollar strength, especially if accompanied by a global economic downturn, is a strong signal to exit these positions. Portfolio weighting is important, and accordingly, a modest level properly sizes the exposure relative to uncertainties. **Outlier scenario ?** With developed stock and bond markets fully valued due to central bank intervention, the emerging markets become a value option not found in many other categories. Fundamentals and momentum align to spur a historic rally relative to developed markets, but vigilance is important.