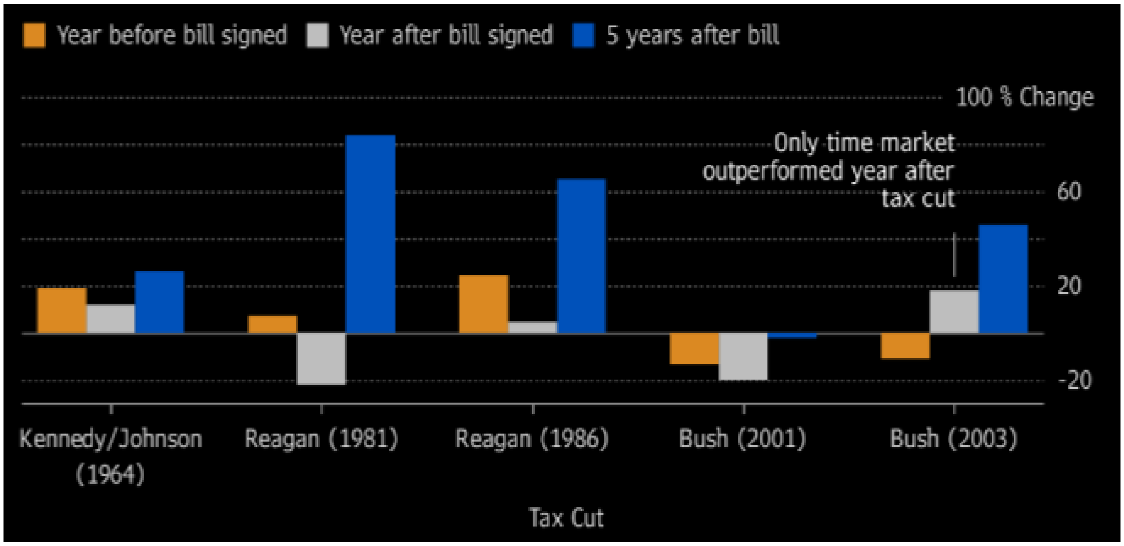
Market Commentary | January 2018
As of December 31, 2017

2017: An Equity Rally Surprising Even to Itself

2017 pushed equity markets further into unchartered territory as major equity indices constantly made new all-time highs. The surge in equity prices, rallying into an uncommon 9th year of a technical bull market, may have caused even the most pessimistic investors to doubt themselves. Tax reform, steady economic data, and confidence in the prediction of Federal Reserve actions were catalysts for the upward movement. The S&P 500 Index, a measure of U.S. large-cap stocks, returned 21.82% year-to-date in the strongest yearly performance since 2013. The 4th quarter alone contributed 6.64% of those returns. By the end of the year, the S&P 500 had its first "perfect" year of monthly performance track record with all 12 months positive (2006 was close with 11 out of 12 months being positive). It wouldn't be surprising if even the most conservative investors threw in the towel to chase equity momentum.

The old adage is all good things must come to an end. The biggest question is when? One of the drivers of positive equity performance this year was investor optimism regarding tax cutting measures. Now that the bill has passed, has the upside already been priced in?

Tax Cut Hype: S&P 500 Index performs better year before tax cuts than year after.



Sources: Bloomberg, SFG. Data based on date bill was signed by each President. For illustration purposes only.

Volatility Fell to Historic Lows – Good or Bad?

While it isn't uncommon for equities to end a calendar year with double digit returns, it is uncommon for double digit returns with such historically low volatility. Against statistical odds, the VIX Index, a measure of expected volatility, fell over 20% during the year and fluctuated around its lowest levels in its history, more than 43% below its historical average. 30-day volatility of the S&P 500 Index reached its lowest levels since the 1960's. This could push a novice investor, or even a sophisticated computer optimizer, to interpret the recent environment as lower risk, ultimately overweighting into equities.

While it has been smooth sailing for the past 12-months, it may be troubling for what's to come in the future. After all, equity risk is still subject to the same market and liquidity dynamics as before. The following chart illustrates that when the VIX Index reaches its lowest levels, it is not everlasting and can often be followed by pronounced and extended spikes.

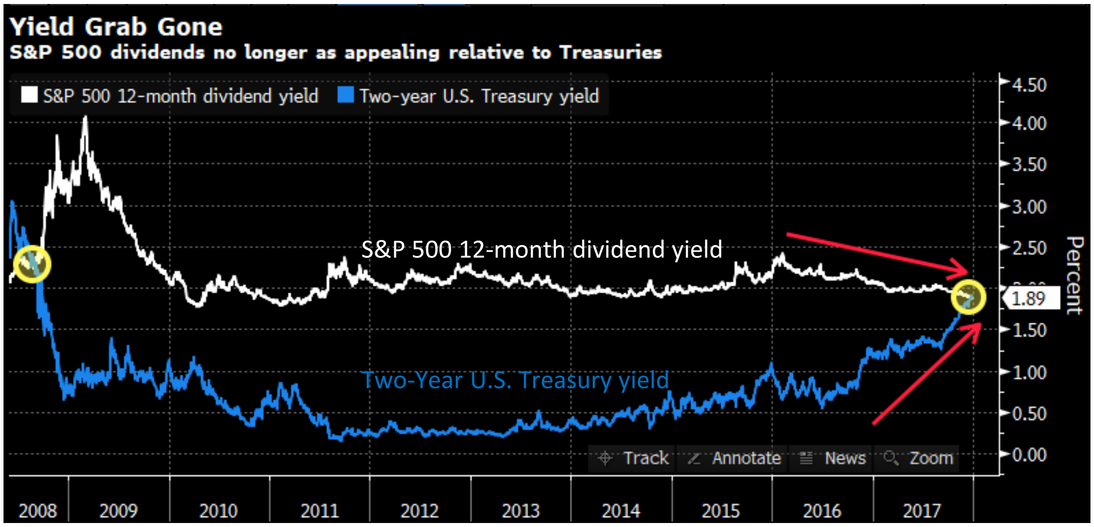
Expected Volatility: Risk of equity downside correction and volatility mean reversion?

Sources: Bloomberg, SFG. Data from 12/31/1990 to 12/29/2017. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

Are Stock Dividends a Fad of the Past?

As U.S. equity prices continue to rise, the relative attractiveness in one of the fundamental supportive characteristics may be falling. For the first time since 2008, the dividend yield on the S&P 500 Index and the yield on the U.S. 2-Year Treasury note are essentially the same. For years after the 2008 financial crisis, the gap between the income generated from holding equities relative to government securities bolstered the case for equities to climb to record highs. As investors searched for yield, the demand dynamic for dividend equities (and specifically high dividend equities) may have been a driving force behind dividend equity returns. However, now that the gap is essentially closed, the dividend factor is likely not a potential source of strong risk-adjusted performance in equities.

Yield Grab Gone? S&P 500 dividends no longer as appealing relative to treasuries.



Sources: Bloomberg, SFG. Data from 6/30/2008 to 12/29/2017. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

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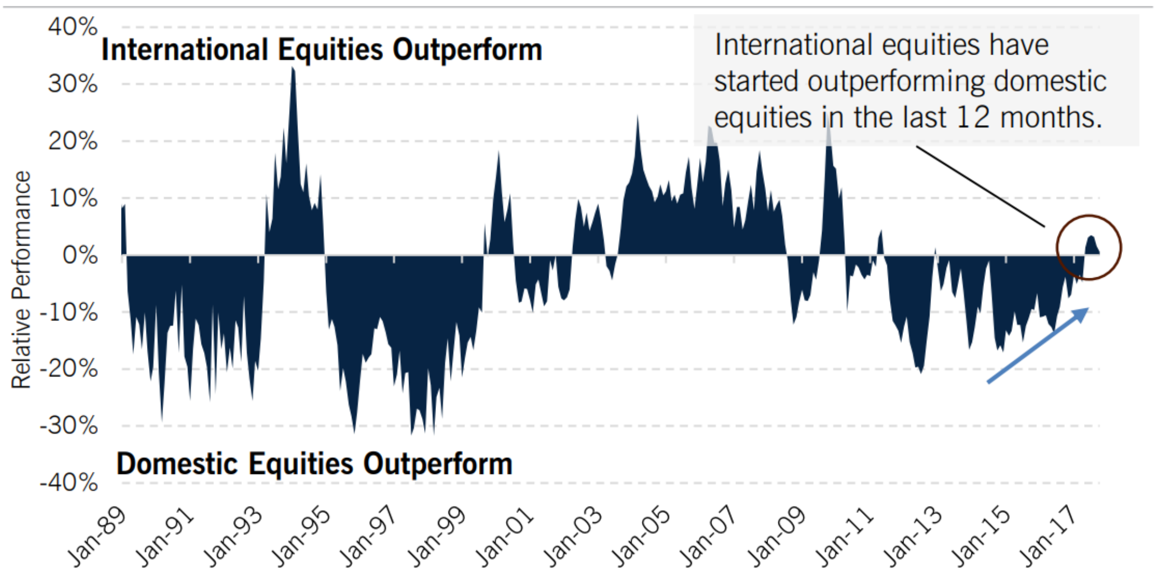
International Relevancy

Another trend during the year was the strong performance (and outperformance) of international equities relative to domestic. Historically, relative outperformance between domestic and international stocks has swung like a pendulum. As domestic equity markets provided U.S. investors with satisfying returns, it isn't surprising that these investors' investment portfolios typically do not contain much exposure to international equities. However, as fundamental valuations have been squeezed with the latest equity rallies, international equities have been argued to be "cheaper." This is coupled with the fact that the Federal Reserve started raising rates in December of 2015, effectively ending a 9-year stimulus package, while the rest of the world's central banks are still supporting their markets. The following chart illustrates the 12-month rolling return differences between domestic equities and international equities over the last 28 years. In 2017, the MSCI ACWI ex US Index outperformed the S&P 500 Index by more than 5.9%.

Changing Trends? Relative 12-month rolling return: MSCI ACWI ex US Index / S&P 500 Index



Sources: Bloomberg, SFG. Data from 1/1/1989 to 10/31/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

Treasury Yield Curve Flattens

While the equity rally steals the show, the movement in the fixed-income market may be the real key to forming ongoing expectations of risk and return. The flattening U.S. Treasury yield curve has been the focus of fixed-income managers and a persistent theme over the past several weeks. To put it simply, the treasury yield curve measures the spread between short-term and long-term debt issued by the U.S. government. It's the extra compensation that investors demand to lock away their money for an extended period of time. The 5-Year and 30-Year U.S. Treasury yields ended the year below 60 basis points, the lowest since November of 2007. As the market prices in more rate hikes from the Federal Reverse, short-end yields climb, while long bonds rally from demand for duration, making the curve "flatter." The yield curve may be the flattest in a decade and an inverted yield curve (when the shorter term debt yields more than the longer term debt) has been a strong historical indicator of an imminent recession. At this point, we are still 60 basis points away from an inverted curve.

Collapsing Curve: Treasury yield spread plunges below 60 basis points for first time since 2007.

Sources: Bloomberg, SFG. Data from 9/30/07 to 12/29/17. For illustration purposes only. Please see disclosures at the end of this commentary for additional important information

The Bond Conundrum Stays

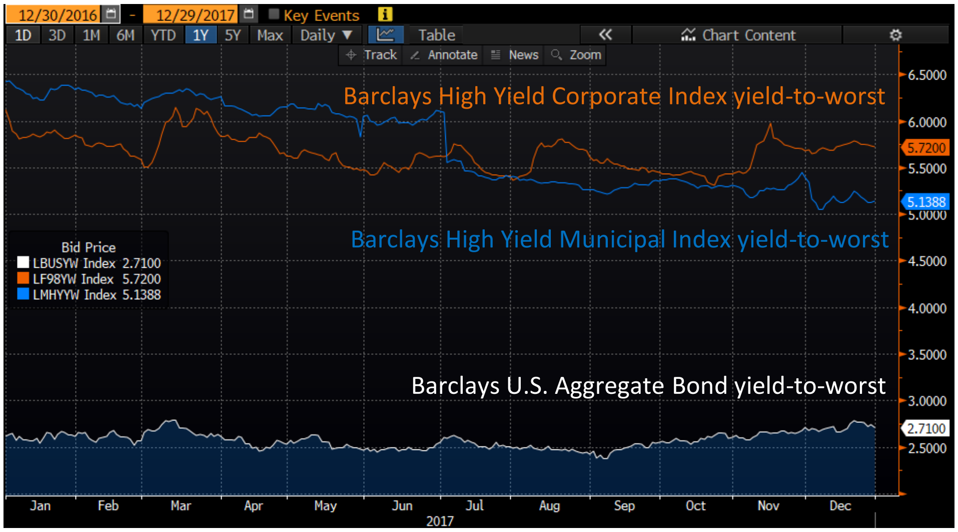
While equities had record setting highs, the overall treasury market ended the year where it started. The U.S. 10-Year Treasury Yield was almost unchanged, ending the year at 2.41% (as of 12/29/17) versus 2.44% the year prior. The current fixed-income environment remains difficult for traditional bond investors with the risk of continued rate hikes by the Fed potentially putting investment grade fixed-income at a disadvantage. The Barclays U.S. Aggregate Bond Index, a widely accepted benchmark for investment grade fixed-income, is virtually flat since the U.S. 10-Year yield bottomed nearly 18 months ago on July 8, 2016. 539 days with only 0.11% total return, barely recovering from one of its longest running drawdowns since the 1980's.

Traditional investment grade bonds flat after held for 539 days

Sources: Bloomberg, SFG. Data from 7/8/16 to 12/29/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information

The Advantage of Higher Yields

High yield fixed-income vs. investment grade fixed-income yield-to-worst (%)



Sources: Bloomberg, SFG. Data from 12/28/16 to 12/29/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information

Not all fixed-income is created equal. High yield corporate bonds and high yield municipal bonds had greater upside this year given their relatively higher yields. The Barclays High Yield Municipal Index and Barclays High Yield Corporate Index returned 9.69% and 7.50% for the year respectively versus the Barclays U.S. Aggregate Bond Index at 3.54% (as of 12/29/17).

Portfolio Recap

The lure of higher yields in the fixed-income space is often overlooked in traditional asset management. The reason is because with higher yields, as expected, comes higher risk. However, non-traditional tactical risk management can attempt to capture a large portion of these returns while seeking to managing downside risk. In our asset allocation portfolios, we seek to pair both strategic (more traditional passive portfolio approach) with active tactical styles. Our tactical fixed-income strategies allowed the portfolios to be invested in high yield corporates and high yield municipals, while providing some comfort of a risk management overlay. On the equity side, both tactical and strategic equity strategies remained fully invested for the year, capturing a substantial amount of diversified equity returns. As mentioned above, domestic equities have seen strong performance. However, trends in international equities continue to perform strongly on a relative basis. Therefore, we believe it is beneficial to add slightly more exposure to international equities, while being cognizant of the overall portfolio risk. Our international strategy is implemented with a tactical risk management overlay. Overall, we seek to react to trends as they present themselves as no one can predict the future. We continue to manage our portfolios with a rules-based methodology, seeking to set the stage for a higher probability of success, whether the markets continue moving higher or reverse course.

Conclusion

2017 has been in many ways spectacular. Equities continuously made new highs on unprecedented low volatility, and traditional bonds, in a way, did nothing. This may lead investors to believe that risk "today" is lower than risk "yesterday." This is a fallacy, as investors should recognize potential risk exposure **every day**. Rather than make drastic changes to a portfolio, now is a good time for careful analysis and consideration of one's risk tolerance. We utilize a quantitative approach, aiming to minimize the subjectivity of investing. For our tactical strategies, this approach employs multiple factors that seek to stay invested when markets are appreciating, while seeking to be defensive in a "risk-off" position during market downtrends.

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Definitions and Indices

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Equity is a stock or any other security representing an ownership interest. **Technical** is a method of evaluating securities by analyzing statistics generated by market activity, such as past prices and volume. **Bull market** is a market condition in which prices are rising or are expected to rise. **Federal Reserve (Fed)** is the central bank of the United States that raises or lowers interest rates. **Large cap** refers to a company with a market capitalization value of more than $5 billion. Large cap is a shortened version of the term "large market capitalization." market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share. **Volatility** is used to describe uncertainty or risk in terms of statistical measure of dispersion (variation in prices) – realized volatility is based on historical volatility while expected volatility is based on a market estimate of future volatility. **Mean reversion** is the theory suggesting that prices and returns eventually move back toward the mean or average. This mean or average can be the historical average of the price or return, or another relevant average such as the growth in the economy or the average return of an industry. **Liquidity** is the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. **Drawdown** is a measure of peak to trough loss in a given period. **Dividend yield** is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price. **U.S. 2-year Treasury Note** is a marketable U.S. Government debt security with a fixed interest rate and a maturity of 2 years. **Fundamental valuation** is a valuation technique used to determine the market value of a stock, common share or equity security. **Yield** is the income return on an investment. This refers to the interest or dividends received from a security. Yield shown may represent different yield types and calculations and varies from index (or asset class) to index determined by availability of data. **U.S. 10-year Treasury** is a debt obligation issued by the United States government that matures in 10 years, backed by its full faith and credit. A treasury bond is a marketable, fixed-interest U.S. Government debt security with a maturity of more than 10 years. **Fixed-income (bonds or investment grade bonds) security**, commonly referred to as a bond or money market security, is an investment that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity. A bond price falls as its yield rises. **Investment grade** is a rating that indicates that a municipal or corporate bond has a relatively low risk of default. **High-yield corporate bond** is a type of corporate bond that offers a higher rate of interest because of its higher risk of default. When companies with a greater estimated default risk issue bonds, they may be unable to obtain an investment-grade bond credit rating. **High-yield municipal bond** is a lower rated security issued by less creditworthy municipalities. As such, they typically offer the highest yields of all municipal bond funds. **Yield-to-worst (YTW)** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Risk-adjusted performance** is the investment's return accounting for how much risk is involved in producing that return. **Rolling 12-month** return is the total return for the 12-months ending with each consecutive month. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. **Basis point** is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. For example 100 basis points = 1%. **Duration** is a measure of the sensitivity of the price - the value of principal - of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. **Total return** is the income return and gains of an investment over a given period. **Tactical** is an asset allocation approach that is geared towards minimizing risk while taking advantage of opportunities, moving in and out of certain investments based on a risk/return evaluation. **Downside risk** is the financial risk associated with losses. That is, it is the risk of the actual return being below the expected return, or the uncertainty about the magnitude of that difference. **Strategic** refers to a portfolio strategy that involves setting target allocations for various asset classes, and periodically rebalancing the portfolio back to the original allocations when they deviate significantly from the initial settings due to differing returns from various assets. **Quantitative** refers to economic, business or financial analysis that aims to understand or predict behavior or events through the use of mathematical measurements and calculations, statistical modeling and research. **Non-traditional** strategies pursue techniques that diverge in some way from conventional, buy-and-hold investing. **S&P 500 Index** is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. Stock market, as determined by standard & poor's. **VIX Index** is the Chicago board options exchange (CBOE) volatility index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. **MSCI ACWI ex USA Index** is a market-capitalization-weighted index maintained by Morgan Stanley capital international (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI all country world index ex-U.S. Includes both developed and emerging markets. **Barclays U.S. Aggregate Bond Index** is an index that consists of investment grade U.S. Government bonds, investment grade corporate bonds, mortgage pass-through securities, and asset-backed securities. It is often considered representative of the U.S. Investment-grade fixed rate bond market. **Barclays High Yield Municipal Bond Index** covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. **Barclays U.S. Corporate High Yield Index** measures the USD-denominated, high yield, fixed-rate corporate bond market.

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