

Independence Asset Advisors, LLC

2017 Year-End Client Letter

Friday, December 29, 2017

With the New Year fast approaching, we are taking this opportunity to share with you, our valued clients and friends, Independence Asset Advisors' 2018 investment outlook. Our outlook for stocks and bonds is derived in large part from our view of U.S. and global economies and concludes with the expectation of another rewarding year for investors.

Economic Outlook

As 2017 comes to a close, the U.S. economy remains strong and is gaining momentum. GDP rose by a greater than 3% annual rate in each of the second and third quarters, and may well rise by 3% or more in the fourth quarter. If so, this will mark the first time in over a decade that the U.S. economy will have seen three consecutive quarters of 3% growth.

At 4.1%, the unemployment rate in the U.S. is historically low, and it is likely to grind even lower in 2018. Jobless claims, likewise, are historically low. Additionally, the housing market is ending the year on a robust note. New and existing home sales are both at decade highs. Not surprisingly, U.S. consumer sentiment has also hit near record high levels, and business confidence is strong.

Against this advantageous economic backdrop, and with monetary policy still accommodative and fiscal policy poised to provide a short-term boost, we believe the U.S. economy will continue this growth trend during 2018.

Importantly, we do not see a meaningful recession risk next year. Reduced corporate and individual tax rates in 2018 should generate a short-term economic stimulus,

pushing any recession out to 2019 or later. Reduced regulation, plus the immediate expensing of capital expenditures by corporations, should provide further support to U.S. economic growth in 2018. Importantly, inflation has remained tame through 2017, but it will likely rise modestly in 2018.

The economic picture is fairly bright throughout much of the rest of the world, as well. We are undeniably in the midst of a rare period of synchronized global economic growth, which appears to be accelerating. For the first time since 2010, all of the countries tracked by the Organization for Economic Cooperation and Development (OECD) are on track to post growth in 2017. The International Monetary Fund (IMF) has raised its forecast for global economic growth to 3.6% in 2017 and 3.7% in 2018. As is the case in the U.S., German consumer and business confidence are both near all-time highs, and Japanese business sentiment is likewise very strong. With central banks around the world remaining accommodative, we agree with the IMF that global economic growth will remain strong in 2018.

Commodity/Currency Outlook

Key commodity prices rose in 2017, reflecting the strong global economic growth seen in 2017 and forecast for 2018. Oil prices in the U.S. are up about 10% this year, and at \$59 per barrel are poised to end 2017 near two-year highs. We expect U.S. oil prices generally to trade in the range of \$50 to \$65 per barrel in 2018. Copper enjoyed an exceptional year as prices finished up over 25% at over \$3.25 per pound and near four-year highs. Even gold, a normally defensive asset, rose about 10% in 2017. The gold price increase (and to a lesser degree the oil and copper price increases) likely had more to do with the decline in the U.S. dollar during 2017, which is set to decline 10% this year as measured by the DXY dollar index. We do expect a stable and perhaps rising U.S. dollar for much of 2018 in part due to the combination of U.S. monetary tightening and fiscal stimulus, but note that larger budget deficits in the U.S. and less accommodative monetary policy abroad may produce headwinds for the dollar later in 2018 and beyond.

Bond Outlook

The secular, 30-year bull bond market likely came to an end post-Brexit in July 2016. While bonds will post positive returns in 2017, our outlook for fixed income in 2018 is cautious. The combination of a stronger economy, fiscal stimulus, less accommodating monetary policy and rising inflation all are supportive of rising bond yields and falling bond prices. Bond yields have risen substantially from their July 2016 lows, but remain at near historically low levels. We see a path of gradually higher yields in 2018, with Fed Funds ending the year 2% or more and the 10-year U.S. Treasury note potentially reaching around 3%. We also note a risk, similar to what was seen in 2003, that tax reform may produce a faster rise in the 10-year U.S. Treasury yield than is currently priced into the market.

However, even with the assumption of sub-par returns in 2018, we continue to believe that bonds are an important part of a balanced investment portfolio as they serve as a hedge against the downside risk inherent in the equity markets and provide a modest level of real income. In a rising rate environment, 2018 is likely to be a year where a focus on yield capturing strategies will optimize the return in bond portfolios and that trading strategies will underperform. It is precisely times like the present to remember the sage advice, “Don’t fight the Fed.”

Equity Outlook

We closed 2017 with major U.S. stock indices at or near all-time highs, including the Dow Jones Transportation Average – an important barometer of domestic economic activity. Indeed, the S&P 500 ended up in December 2017, marking the first year **ever** when the S&P 500 posted positive total returns in every month of the calendar year. We are clearly in the midst of an extraordinary equity bull market. Many are wondering whether the bull market will continue in 2018. We are left grappling with the question: Is all the good news already priced in to the market?

Our forecast is that equity markets will continue to gain in 2018, albeit with markedly higher volatility. Strong and improving U.S. and global economies support this outlook, as does a strong corporate earnings climate. However, with equity valuations in the

U.S. stretched, we expect U.S. equity gains to be muted and constrained by earnings growth in the mid-single digits. The S&P 500 has not had a 10% or more correction in almost two years. It is likely that this remarkable run will end, as we expect several pullbacks and at least one correction of 10% or greater in 2018. With accelerating earnings growth in Europe and many international markets, international equities (EAFE) are poised to outperform domestic stocks over the next few years.

The potential risks to the equity markets in 2018 are many, including: continuing dysfunction in Washington D.C. (a budget deal needs to be reached in mid-January); inflation accelerating more quickly than markets anticipate; the Federal Reserve adopting a more hawkish approach to monetary policy than expected; U.S. immigration policies exacerbating skilled labor shortages; and U.S. trade policy becoming more combative and leading to disruptions in supply chains. We also need to be mindful that November 2018 mid-term elections will in all likelihood increase policy uncertainty. Outside of the U.S., China – now a positive contributor to the global economy – is a source of potential economic turmoil. Should its growth rate slow, its currency weaken appreciably, or a debt crisis emerge, emerging markets and large developed market trading partners could be negatively impacted. Geopolitical conflict always poses a risk, whether with China, North Korea, Russia or the Middle East, but these setbacks are nearly always temporary. Ultimately, recessions produce two out of three bear markets and aggressive Fed tightening accounts for the rest. With no recession foreseen before the second half of 2019 or later, we are optimistic that 2018 will be another positive year for equities.

In the environment described above, we believe active management and stock selection will take on greater importance. We stress the benefits of diversification and thoughtful asset allocation in a rising risk environment.

Conclusion

Overall, we think 2018 will be a rewarding year for investors as the earnings-driven equity market continues, notwithstanding markedly higher volatility, to provide positive returns. Although pullbacks may become more frequent and more pronounced, the

ultimate path of the market should take an overall higher trajectory. Rebalancing may add more value with increased volatility and a rotation to safer assets may be warranted for more cautious investors.

One last word about risk management. We are clearly late in the cycle of a long economic and market expansion. Credit markets may be the harbinger of future headwinds as the yield curve has flattened in a slow growth, low inflation, rising rate environment. Although we are not calling for a recession in the next 18 months or more, recessions are rarely foreseen before markets react. The time to prepare for the next downturn is before the storm.

Our outlook remains positive as our goal is clearly to protect and participate. Protect capital against large down-side losses while participating in market gains to produce above average risk adjusted return over market cycles.

We wish everyone a healthy, peaceful and prosperous New Year and encourage you to contact us with any questions or concerns as 2018 unfolds.

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