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THE ADVISOR

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2018 Will Be Another Double-Digit Year for the Stock Market, But...

You don't need me to tell you 2017 was a banner year for the stock market. The Dow gained over 25 percent, the S&P 500 added about 20 percent, and the NASDAQ nearly 30 percent.[1] Looking ahead, we're forecasting another double-digit year for the markets in 2018, but there's a catch: that double-digit number could come in the form of more gains or big losses.

If you've been reading this newsletter for a while, you already know we believe the stock market is overdue for a major correction—and most experts are now saying it. Ironically, as the markets have soared to new record heights since Donald Trump's election, more and more economists have come to recognize that due to the lingering effects of quantitative easing, the markets are dangerously disconnected from economic realities, and eventually they will have to make fundamental sense again.

This disconnection became more obvious than ever in 2017. Yes, the economy saw modest improvement with the GDP up from 2016, unemployment down further, and wages no longer completely stagnant. But none of that adds up to an economy booming at record levels. Only the stock market did that, driven mainly by optimism over the promise of Republican tax reform.

Though the tax plan is now law, many economists are skeptical it can deliver the kind of sustained economic growth Trump has boasted. That's concerning because Wall Street has already priced that growth into the market, and the tax plan almost has to deliver 4 percent or greater GDP growth in order for the economy to catch up with overinflated stock prices. If that scenario doesn't pan out, there's only one other way for the markets to make fundamental sense again: a double-digit pullback, which history suggests could be anywhere from 40 to 70 percent.

Animal Spirits

While that could happen in 2018, there's also a possibility that more double-digit growth could occur based on momentum. That's

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Assessing Your Risk Tolerance

While investors want the highest returns possible, returns compensate you for the risks you take — higher risks are generally rewarded with higher returns. Thus, you need to assess how much risk you are willing to take to obtain potentially higher returns. However, this can be a difficult task. It is one thing to theoretically answer questions about how you would react in different circumstances and quite another to actually watch your investments decrease significantly in value. What you are trying to assess is your emotional tolerance for risk or how much price volatility you are comfortable with. Some questions that can help you gauge your risk tolerance include:

- **What long-term annual rate of return do you expect to earn on your investments?** Your answer will help determine the types of investments you need to choose to meet that target. Review historical rates of return as well as

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Double-Digit Year

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because "animal spirits" are still running rampant on Wall Street. That's the term coined by economist John Maynard Keynes to describe human behavior driven by instinct and emotion. Animal spirits are the reason the market set close to 70 new record highs last year, while the economy broke no records at all.[2]

This year, the animal spirits could go on howling loud enough to continue building up the "froth" or blow-off that already characterizes this market — meaning an impressive head of foam on top of a glass that was already full. That's why this market forecast is based on double-digit movement in either direction. If there is enough continued economic progress to keep the froth building, we could see double-digit growth again in 2018. In fact, we believe the momentum will continue in the beginning of the year; as to whether it continues the entire year is another question.

Of course, the more important question for investors near retirement is this: is it worth the risk when a double-digit drop is equally possible based on economic realities? In fact, according to some key details, the economy actually isn't doing that much better than it was two years ago!

It was two years ago last month that we first discussed concerns about the Federal Reserve's just-announced timeline for raising short-term interest rates. That was right after the Fed approved its first interest rate increase since lowering short-term rates to nearly zero in 2008, just before launching quantitative easing.

At the time, we were skeptical about the Fed's goal of having short-term rates up to 2.5 percent by the end of 2017 for two reasons: First, it would strengthen the dollar and make it very difficult to hit their goal of 2 percent inflation. And second, raising short-term rates that high would mean in order to avoid flattening the yield curve, long-term rates would also have to increase by at least 2 percent by the end of 2017 — which was very unlikely to happen.

Warning Signs Persist

Well, guess what? Although the Fed has approved four additional rate hikes since that first one two years ago, the current Fed funds rate is still just in the range of 1.25 to 1.5 percent at the start of 2018, and the goal of 2.5 has been pushed back to the end of 2019.[3] Why? For exactly these reasons: inflation has mostly stayed below 2 percent, and long-term rates have not risen ahead of short-term rates enough to avoid risking a flat yield curve. The 10-year Treasury rate was at 2.25 when we shared doubts about it reaching 4 to 5 percent by the end of 2017. Today it is just at 2.47 percent.[4]

We've discussed importance of the yield curve several times. Keeping long and short-term rates separated by at least 2 percentage points is essential, because banks depend on that gap to make lending worth their while. When the yield curve flattens, banks lose their financial incentive to lend, and businesses and consumers struggle to borrow. That's not a recipe for economic growth, but just the opposite. It's the kind of thing that could stall an economy completely, put an end to animal spirits and irrational exuberance, and finally force the stock market to make fundamental sense again with a major pullback.

Recently, there was another vivid example of how other economic experts are now recognizing the importance of some of the same details we have focused on. There was a CNBC interview recently with one of the Federal Reserve's regional presidents, who actually voted against their most recent rate hike. He explained his opposition by sharing some of the same concerns shared two years ago — including the risk of a flat yield curve![5]

He explained how continuing to raise short-term rates while long-term rates are still low could bring the current course of economic improvement to a screeching halt.

The interview made us realize that those warning signs from two years ago are still in place, but even a member of the Fed admits to being concerned about them today!

1 CNN Money, "Dow Enters Final Week of 2017 Up 25 Percent, Poised for Best Year Since 2013" *Space Coast Daily*, December 27, 2017. *http://spacecoastdaily.com/2017/12/dow-enters-final-week-of-2017-up-25-percent-poised-for-best-year-since-2013/*

2 Amadeo, K., "Dow Highest Closing Records," *The Balance*, December 18, 2017, *https://www.thebalance.com/dow-jones-closing-history-top-highs-and-lows-since-1929-3306174*

3 *Fedprimerate.com*

4 *Ycharts.com*

5 Lovelace Jr., B., "'It's not the Fed's job to protect investors from losses, says central banker Kashkari'" *CNBC*, December 19, 2017, *https://www.cnbc.com/2017/12/19/ feds-kashkari-it-is-not-my-job-to-protect-investors-from-losses.html*

Risk Tolerance

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variations in those returns over a long time period to see if your estimates are reasonable. Expecting a high rate of return may mean you'll have to invest in asset classes you aren't comfortable with or that you may be tempted to sell frequently. A better alternative may be to lower your expectations and invest in assets you are comfortable owning.

- **What length of time are you investing for?** Some investments such as stocks should only be purchased for long time horizons. Using them for short-term purposes may increase the risk in your portfolio, since you may be forced to sell during a market downturn.
- **How long are you willing to sustain a loss before selling?** The market volatility of the past several years will give you some indication of how comfortable you are holding investments with losses.
- **What types of investments do you own now and how comfortable are you with those investments?** Make sure you understand the basics of any investments you own, including the historical rate of return, the largest one-year loss, and the risks the investment is subject to. If you don't understand an investment or are not comfortable owning it, you may be tempted to sell at an inopportune time. Over time, your comfort level with risk should increase as your understanding of how risk impacts different investments increases.
- **Have you reassessed your financial goals recently?** Due to the significant market volatility of the past few years, your financial plan may need to be revamped. Otherwise, you may find you won't have sufficient resources in the future to meet your goals. Based on your current investment values, determine what needs to be done to meet your financial goals. You may need to save more, change or eliminate some goals, or delay your retirement date.
- **Do you understand ways to reduce the risk in your portfolio?** While all investments are subject to risk, there are some risk-reduction strategies you should consider for your portfolio. These strategies include diversifying your portfolio, staying in the market through different market cycles, and using dollar cost averaging. Please call if you'd like help assessing your risk tolerance.

The ABCs of Risk Premiums

Investing in the financial markets is inherently risky. There's never a guarantee you'll make a certain return on your investment or even that you'll get back what you put in. Of course, some investments are riskier than others, but they tend to offer potentially higher rates of return. That difference in expected return for riskier investments is called the risk premium. It's the investor's reward for taking greater risk.

To better understand risk premiums — what causes risk and why risk premiums are important — let's take a look at the anatomy of an investment's return, which has three components:

- **Inflation** — Inflation is the rate at which prices increase, typically hovering between 2% and 4%.
- **Risk-free rate of return** — A risk-free rate of return is the return on an extremely low-risk (so low it's termed risk free) investment. Typically, investors look at the short-term interest rate on a Treasury bill (T-bill) as a risk-free rate. Investors view the backing of the U.S. government and their short maturity as signs of the investment's stability and liquidity, in other words, low risk.
- **Risk premium** — The third component of an investment's return is the risk premium. On short-term T-bills, the risk premium is zero — those investments are considered risk free. But other investments, including stocks, have added elements of risk. A risk premium is the excess return of an investment that is greater than the risk-free rate of return.

What Causes Risk?

Broadly, there are three reasons that some investments are more risky than others:

- Returns on stock investments can fluctuate, unlike predictable bond coupon payments.
- Corporate bond holders have the first claim to corporate earnings before stock holders, who have a residual claim.
- Stock returns tend to be more volatile.

Historically, bonds and cash equivalents tend to be less risky than stock investments. But even among stocks, risk premiums vary. A company with historically stable stock returns, a long earnings history, and a conservative growth plan will likely have a lower risk premium than a new company that's growing quickly and aggressively.

Why Are Risk Premiums Important?

Understanding risk premiums is the first step in creating an asset allocation plan for your investments. To determine which assets to invest in, you'll have to determine the optimal risk-premium mix for you.

Some investors tolerate risk quite well, while others do not. You need to honestly assess your risk tolerance level, so you can determine the amount of risk that best suits your particular needs.

Please call to discuss the implications of risk premiums on your portfolio.

Business Data

	Month-end				
Indicator	**Oct-17**	**Nov-17**	**Dec-17**	**Dec-16**	**Dec-15**
Prime rate	4.25	4.25	4.50	3.75	3.50
3-month T-bill yield	1.02	1.29	1.45	0.56	0.26
10-year T-note yield	2.33	2.37	2.46	2.55	2.24
20-year T-bond yield	2.61	2.62	2.66	2.86	2.60
Dow Jones Corp.	3.08	3.11	3.13	3.17	3.43
GDP (adj. annual rate)#	+1.20	+3.10	+3.20	+2.10	+1.40

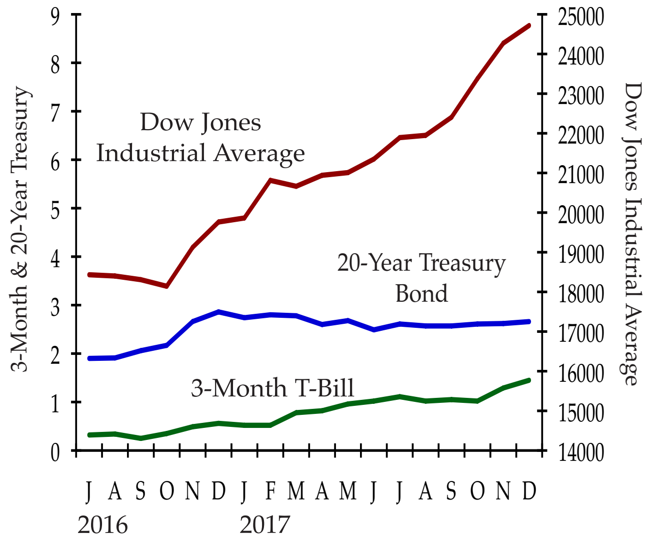
	Month-end			% Change	
Indicator	**Oct-17**	**Nov-17**	**Dec-17**	**2017**	**2016**
Dow Jones Industrials	23377.24	24272.35	24719.22	25.1%	13.4%
Standard & Poor's 500	2575.26	2647.58	2673.61	19.4%	9.5%
Nasdaq Composite	6727.67	6873.97	6903.39	28.2%	7.5%
Gold	1270.15	1280.20	1296.50	11.9%	9.1%
Unemployment rate@	4.20	4.10	4.10	-10.9%	-8.0%
Consumer price index@	246.80	246.70	246.70	2.2%	1.7%
Index of leading ind.@	128.90	130.40	130.90	5.6%	0.1%

\# — 1st, 2nd, 3rd quarter @ — Sep, Oct, Nov Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

July 2016 to December 2017



Avoid Five Common Investing Mistakes

1. **Putting all your investment eggs in one basket.** Diversification is a familiar term in investing. Investing in a variety of investment alternatives helps to decrease risk. If you have all your money invested in one company and that company does not perform well, your portfolio is going to suffer. However, by diversifying your portfolio, your overall return will not be as drastically impacted by the poor performance of one company.
2. **Spreading your investments too thin.** While there is value in diversification, overdiversification can be problematic. With too many investments in your portfolio, each investment has little impact on your total return.
3. **Expecting instant gratification.** Investing takes patience. When investors jump into an investment seeking to get rich quick, they often find themselves giving up on an investment too quickly and miss out on returns that might have materialized over time. If you select an investment after careful research, you don't need to monitor its every movement. Most investments will fluctuate, but good investments tend to appreciate over time.
4. **Neglecting risk level assessment.** Before investing money, you need to assess the investment's potential for both upside and downside gains and losses. When you understand the risk an investment faces, you are less likely to sell based on emotion.
5. **Skipping out on an investment education.** Many people invest without knowing anything about the markets or the field of investing. Whether the cause is time constraints or confusion, lack of education can be harmful to your portfolio. You need a solid understanding of invest basics. Once the education piece is in place, investing becomes much more interesting.

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