Wealth Advisory Group, Inc.
A Registered Investment Advisory Firm

Wealth Advisory Group – Review and Outlook – Q4 2017

Economic and Market Review

Economy – In our year-end 2016 Review and Outlook, we noted the dichotomy between actual economic growth (low) and expectations (high) going into 2017 and as the year unfolded, we saw both scenarios play out. The economy started slowly with GDP growth of 1.2% in the first quarter and then roared to life in the second half with back to back 3% plus growth in Q2 and Q3 and strong estimates for the fourth quarter and 2018. Many leading and coincident are confirming the economic strength including the Citigroup Economic Surprise Index which is near all time highs. Employment continues to be strong with the availability of qualified workers starting to become a problem. Wage growth has lifted from the moribund post Crisis levels yet remains relative tame at just under 3%. All in all, there are few if any signs of any impending slowdown and now overheating has become a greater likelihood than weakness as we look forward.

Across the globe, a synchronized recovery is underway with only the UK and China showing any signs of stagnation. While global economic activity is picking up, inflation appears tame and central banks have moved from accommodative towards more neutral policies. The requisite list of geo-political hot spots continues to provide a worrisome backdrop, but the overall health of the global economy continues to improve and that is being reflected in the performance of international markets, both equity and fixed income.

Washington has provided a never-ending fodder for the pundits while only producing a few important policy initiatives. Most notable was the passing of major tax reform, which will cut taxes for most Americans, make U.S. corporate tax rates competitive on a global basis and force companies to repatriate overseas profits. More difficult to quantify but nonetheless impactful has been the effort to lower the regulatory burden on commerce. So, despite all the political bluster, the climate for business is improving and that is being reflected in the economy, corporate profits and the stock market.

Interest rates – The Fed has signaled to investors through words and actions their intention to increase rates. On the short end of the yield curve there were three hikes to the Fed Funds rate and three hikes forecasted for 2018. Efforts to shrink the Fed's balance sheet and reverse the impacts of Quantitative Easing (QE) began in the fourth quarter. The net impact has been a flattening of the yield curve as short and intermediate term rates rose while long term rates inexplicably dropped slightly during 2017.

Markets – Equity markets around the world posted double digit gains in 2018. The S&P 500 was up 21.8% as growth stocks led the way with a 30.9% return for the Russell 1000 Growth Index, well ahead of the 14.2% for the Russell Value Index. Smaller US stocks lagged as the Russell Mid Cap delivered 19.1% and the Russell 2000 only managed a 15.6% return. International stocks performed well as developed markets were up 25.2% as represented by the MSCI EAFE Index and MSCI Emerging Market Index was up a remarkable 36.9%.

Dollar & Commodities – The Dollar exhibited some weakness from the highs of late 2016, which has helped the competitiveness of US companies and S&P 500 earnings with better currency translation, while also boosting the returns of unhedged foreign investments. Commodities have shown some strength in 2017 driven by better global economic conditions. Crude Oil finished the year above $60, the highest level since mid 2015. Gold was modestly higher, while the Grains complex was down in 2017.

1055 Westlakes Drive • Suite 130 • Berwyn • PA • 19312
Main (610) 225-1000 • Toll Free (800) 322-5465 • Fax (610) 225-3036 • www.WealthAdvisoryGrp.com

Outlook

Economy – All signs currently point to building economic strength both domestically and abroad. Changes in U.S. tax policy will have meaningful impact on both consumer and corporate behavior, fueling growth. While the current economic cycle has been unusually long, the tepid early growth means there still is additional runway for the economy. However, the growth invigoration may portend the economy is entering the latter innings of the current cycle and investors need to start contemplating strategies for the inevitable inflationary pressures, increased interest rates and end of the expansion.

Equity Markets – Despite the strong performance of the stock markets in 2017, equity market valuations did not materially increase as robust earnings growth provided support for the rise in price and can sustain further gains. Long bull markets with above average valuation foreshadow diminished expected returns and greater probability of downturn. Asset allocations are also vulnerable to strong equity markets, as actual weights can drift from targets. We continue to favor international markets and reallocating profits from large growth to small and value oriented stocks.

Fixed Income – The Fed has signaled in no uncertain terms their intent to normalize the balance sheet and unwind the effects of Quantitative Easing (QE). Researchers and market observers believe the impact of QE lowered long term rates by 1%, so we can expect those rates to retrace their steps as the process unfolds. The interest rate sensitivity of the bell weather bond index, the Bloomberg Barclays US Aggregate Bond Index, has risen to all-time highs with a duration of 6.0 years. Therefore, the average bond investor is accepting greater interest rate risk at a treacherous point in the rate cycle, while at the same time investors in shorter term bonds are now being compensated with rates much higher than this time last year. We favor riding out the rise in interest rates in the short end and extending durations afterwards.

Thoughts on Bitcoin - Unfamiliar words like blockchain and cryptocurrency have slipped in to the financial lexicon as the Bitcoin frenzy has continued to grow. We have been researching the implications and have two preliminary observations. First, cryptocurrencies, like Bitcoin, have roots in a fundamental lack of trust or actual disdain for establishment. Widespread use of cryptocurrency means governments face threats to their authority to tax and police transactions, while financial institutions may see erosion to their profit margins. These issues must be resolved before mainstream adoption occurs. Secondly, this is first and foremost a technological innovation, which may have widespread implications across many industries. Just as in the *dot.com* days of the late 1990's, many concepts are conceived but only a very select few will actually become robust businesses like Amazon, Google or Microsoft. We will continue to monitor the space looking for opportunity and threats.

1055 Westlakes Drive • Suite 130 • Berwyn • PA • 19312
Main (610) 225-1000 • Toll Free (800) 322-5465 • Fax (610) 225-3036 • www.WealthAdvisoryGrp.com