Economic data strengthened throughout 2017, defying the expectations of economists and investors. After a lackluster 2016, the year-over-year index of leading economic indicators accelerated aggressively, and the Citi economic surprise index climbed to historic highs. Unemployment dropped by 0.6% to a 17-year low of 4.1%, while wage growth remained conspicuously muted, keeping labor cost increases minimal and sustaining corporate profit margins.

While it may seem appealing to ride the market's momentum, and to be optimistic at the end of a year of strong performance, we believe that the current elevated expectations will make it very difficult to match the investment performance of 2017. In our view, the outperformance of defensive equity themes in 2017 reflects many investors' recognition that the economic cycle is extended and that caution is warranted. As accountants, taxpayers, businesses, and the market begin to understand the uncertain effects of the new tax bill, we believe that this caution remains appropriate and core to our goal of preserving capital.

REVIEW OF FOURTH QUARTER PERFORMANCE

Equity markets saw continued, steady gains in the fourth quarter, with the S&P 500 completing its first ever "perfect year" of recording positive gains each month. Meanwhile, defensive themes including large-capitalization and growth companies continued to outperform, suggesting that U.S. investors are cautious about the potential for higher economic growth. The S&P 500 returned +6.64% for the quarter and +21.82% for the year, while the S&P 600 small-cap index returned +3.90% for the quarter and +12.15% for the year. The Russell 1000 Growth index returned +7.86% for the quarter and an impressive +30.21% for the year, while the Russell 1000 Value index ended up +5.31% and +13.64% for the quarter and year, respectively. All sectors of the S&P 500 saw positive returns in the fourth quarter, though the Energy and Telecom sectors still ended the year down -1.01% and -1.25%, respectively. Oil prices climbed +16.93% during the quarter, with a barrel of West Texas Intermediate oil ending the quarter at a value of $60.42. This lifted the Energy sector by +6.02% but did not outweigh its losses from earlier in the year. The dollar stabilized, gaining +0.73% and tempering the recent outperformance of international stocks. The MSCI All Country World index excluding the U.S. returned +5.00% for U.S. investors during the quarter, and 27.19% for the year, supported by the dollar's weakness in prior quarters.

Government bond yields rose throughout the fourth quarter, and the yield curve continued to flatten, as it had throughout 2017. The Barclays Government/Credit Intermediate Index lost -0.20% during the quarter, while still up +2.14% for the year. The tax bill did not remove municipalities' access to tax-exempt financing, and the Barclays Municipal Bond Index gained +0.75% for the quarter and +5.45% for the year, reversing its 2016 underperformance related to this concern.

Against the backdrop of strong market performance, largely attributable to economic data improvement, the on-going drama of the Republican tax bill was a high-profile feature of 2017. Its potential effects are central to many consumer, business, and investor outlooks, and yet are still unclear, due to the hurried and secretive process of passing the bill. Disentangling the effects of the bill on changes in consumer and business behavior from the natural progression of the economic cycle is extremely difficult. While some economic trends can be anticipated and explained, the impacts of the bill are largely uncertain, and are only a small part of what will determine the economy's path forward.

THE UNCERTAIN FOUNDATIONS OF CONSUMER AND INVESTOR OPTIMISM

As we analyze the tax bill in relation to the economy, we can observe some things with confidence. We know, for example, that an economic expansion has been in place since late 2009, and that unemployment has steadily declined since early 2010. We also know that international economic growth has been more variable, but has recently been accelerating, supporting exports and multinational corporation revenues. We know that the tax plan will increase most corporations' profits by lowering their tax rates. We cannot know, however, whether this will cause significant increases in capital investments, hiring, and wages, beyond what would have happened in the absence of the tax bill. Recent company survey data has been mixed, suggesting that some companies are likely to increase these expenditures, while others are more likely to pay out profits to shareholders by means of dividends and share buybacks. In our experience, long term demand forecasts are significantly more important for determining corporate investments in plant and equipment than tax rates and deductibility. We also note that late stages of the business cycle are consistently associated with rising wages, and that the economic developments of 2018 will be affected by many other factors in addition to the tax bill. Thus, we do not believe that the bill merits the Republicans' expressed optimism that it will dramatically alter the direction of the economy or improve the fates of the middle class, and we note that elevated expectations and valuations present increased risks of economic and market underperformance.

THE TAX BILL'S UNEQUAL IMPACTS

We believe this hastily developed, thousand-page tax bill has grave implications for inequality in America. Though Republicans tout the bill as a "middle-class tax cut," the Joint Committee on Taxation's analysis shows that tax cuts for the highest income brackets are both substantially greater, and phased out more slowly, than those for most Americans. As discussed in more detail in our Thinking Capital column in Trillium's *Investing for a Better World* newsletter, our moral concerns extend to many other components of the tax bill. The cumulative effects of the bill are uncertain, but we fear that it will have dangerous, unjust, and long-lasting effects on the balance of income and wealth across America. Further, we find it appalling that these effects were deemed to be mere bargaining chips in the pursuit of corporate tax cuts.

INTERNATIONAL RISK

We enter 2018 monitoring an evolving array of geopolitical risks. Russia has announced its intention for a permanent military presence in Syria, where it supports President al-Assad's government in conflict with U.S.-supported rebels. North Korea continues its missile testing and now claims the capability for a nuclear strike anywhere in the continental U.S. We cannot dismiss the possibility that the new tax bill will fuel a race to the bottom, in which other countries cut their own corporate tax rates to remain competitive. President Trump's stated goal of implementing "America first" trade policies make such a protectionist global economic environment likelier still. Geopolitical events are largely unpredictable by nature, but pose greater risk in a market environment characterized by elevated valuations.

VALUATION AND POSITIONING

Equity prices moved in parallel with economic data and earnings forecasts during the quarter, leaving valuations at the same, somewhat elevated level as at the end of the third quarter. The S&P 500 index closed the quarter at 18.2 times expected earnings for the next twelve months, slightly over the 25-year average of 16.0 times earnings. The cyclically adjusted P/E ratio, which uses the average of ten years trailing earnings, is at 33.2 times earnings, 1.1 standard deviations over the 25-year average. Compared to the current S&P 500 earnings yield of 5.4%, the yield on the 10 Year Treasury Inflation Protected Securities is just 0.4%, indicating that stocks should return about 5.0% more than bonds. We note that this estimate was the same for 2017, and is only a rough guide of market signals. Despite the continued potential for strong returns in the equity market, we believe that current valuations and economic conditions also present significant risks. We believe that the expectations for higher growth embedded in current stock market valuations, including the optimism surrounding the tax bill, will moderate to a level more consistent with the post-financial crisis average. As a result, we continue to maintain a neutral equity exposure for portfolios with discretionary allocations, as well as a risk-neutral positioning in our equity strategies.