2017 Fourth Quarter Portfolio Review

Market Overview

Taking a look back at 2017, global stocks, as measured by the MSCI All Country World Index, finished with a gain of 23.97%, with foreign markets leading the way due in part to a weak U.S. dollar. Emerging markets (EM) represented the strongest performers globally, with the MSCI Emerging Markets Index gaining 37.75% in U.S. dollar terms and 30.55% in local currency terms. Japan and Europe also posted strong gains with the MSCI Japan Index gaining 23.76% and the MSCI Europe Index gaining 26.62%. In this case, the weaker dollar played an even more significant role as European stocks only gained 13.06% in local currency and Japanese stocks gained 19.75% in yen. U.S. stocks were not left behind as the S&P 500 Index finished the year with a gain of 21.83%. Small-cap stocks, as measured by the Russell 2000 Index, finished the year with a gain of 14.65%. The gains were certainly impressive, but when we look behind the curtain we learn some very interesting facts, most notably that U.S. stocks have gone 282 days without a 3% correction as of year end—the longest period in history. Additionally, 42 of the 44 stock markets followed by MSCI posted gains as well as nine of the 11 sectors. The most unusual sector was energy, which posted a decline for the year despite the rise in oil prices, marking the first time in 15 years that the energy sector declined while the price of oil rose. Energy also posted the biggest sector swing in year-over-year earnings ever aside from the financials sector during the 2008-2009 financial crisis. This decline is likely a positive sign for energy stocks going into 2018.

Not to be outdone, bonds also had a very strange year. Global bonds, as measured by the Bloomberg Barclays Global Aggregate Index, increased by 7.65%; yet much of the gain can be attributed to currency effect as the local currency version of the index only increased by 3.04%. This number placed global bonds in a very similar position as U.S. bonds, which increased by 3.80% for the year, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. Once again, emerging market bonds were the strongest performers with the Credit Suisse Emerging Market Corporate Bond Index rising 9.50% and the Bloomberg Barclays Emerging Market Bond Index rising 10.28%. Domestic credit investors were also rewarded for the year with the Bloomberg Barclays U.S. Corporate High Yield Bond Index rising 7.52% and the Bloomberg Barclays U.S. Municipal High Yield Index rising 9.95%. It is notable, however, that the volatility of most bond asset classes was unusually high in 2017, which is in direct contrast to stocks, which spent most of the year hugging all-time lows in terms of volatility.

Portfolio Overview

Salient U.S. Dividend Signal Portfolio returned 6.21% (net performance) in the fourth quarter, slightly underperforming its benchmark, the S&P 500 Index, which returned 6.64%. For the full year, the portfolio had a total return of 18.67% versus the benchmark's 21.84%. Growth stocks continued to outperform value stocks: the Russell 1000 Growth Index returned 7.86% in the fourth quarter versus the Russell 1000 Value Index return of 5.31% and returned 30.21% for the full year 2017 versus value's 13.64%. This wide outperformance of growth over value has been in place since the bull market began in March 2009. A large part of the reason for the divergence between growth and value is due to the current economic expansion being the weakest since World War II (through the first quarter of 2017, it averaged about 2.2%). However, for the past three quarters ending in December 2017, gross domestic product (GDP) growth has improved with estimates showing that a third consecutive quarter of GDP growth of about 3% is likely. The current outlook for fourth quarter GDP is at 3.4%, as measured by the Federal Reserve Bank of Atlanta's GDPNow Forecast (second quarter GDP was 3.1% and third quarter was 3.2%). Stronger GDP growth of 3% or better may mean that value stocks will start to catch up to growth stocks in 2018. U.S. equity markets also saw record low volatility in 2017 and a positive total return for the S&P 500 every month of the year for the first time in its history. The low volatility, strong equity market environment may be due to the improving global growth backdrop as the world's major economies and the emerging markets are all looking relatively healthy at the same time.

In the fourth quarter, the portfolio's top performing sector was industrials. The top performing stock for the quarter and the full year was Wal-Mart. The company continues to improve through its investment in online initiatives, store improvements and employee wages. The weakest sector in the quarter was consumer discretionary while the weakest performing name was KLA-Tencor in the information technology sector. We still like the company and its prospects. At quarter end, the portfolio was more attractively valued than the benchmark with a price-earnings ratio of 20.2x versus the benchmark's 22.3x.

Investment Outlook

Continuing late 2016's momentum, the global economy accelerated in 2017, ending two years of slowing growth. We expect 2017's real global GDP growth to come in around 3.2% versus 2.5% for 2016. Major economies, like the U.S., Europe and Japan, and most emerging markets contributed to the largest global economic acceleration since 2010. Predictably, global confidence increased and the positive business climate pushed equities higher in 2017. For 2018, absent a major negative geopolitical event, the generally solid fundamentals suggest continued global economic improvement, although we believe the global economy will not return to the performance levels achieved in 2003 through 2007 due to structural challenges of high debt, an aging demographic and moderate productivity improvement. We expect less improvement in Europe and Japan relative to the U.S. in developed markets and look for better EM economic growth in Asia.

We believe the U.S. will likely overcome the drag from monetary policy normalization. The proposed tax reform passage should support U.S. GDP growth and corporate earnings growth. Some labor slack remains, but more wage hikes add to consumer incomes. Increased household wealth from higher equity and home prices leads to increased confidence, which should boost hiring and capital spending. Hurricane-related rebuilding adds to the recovery and dollar weakness, which favorably impacts corporate earnings. Generally, U.S. equity valuation is not as attractive as other parts of the world and we believe stock selectivity will play a major role in 2018 performance.

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Net returns are calculated using a highest management fee of 2.00%, applied monthly.

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Bloomberg Barclays Global Aggregate Index represents a broad-based measure of the global investment-grade fixed income markets, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays Emerging Market Bond Index is an unmanaged index that tracks total returns for external-currency-denominated debt instruments of emerging markets located in the Americas, Europe, Middle East, Africa and Asia.

Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are U.S. domestic, taxable and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Corporate High Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Municipal High Yield Index measures the noninvestment-grade and nonrated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington D.C., Puerto Rico, Guam and the Virgin Islands).

Credit Suisse Emerging Market Corporate Bond Index consists of U.S. dollar-denominated fixed-income issues from Latin America, Eastern Europe and Asia.

MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Europe Index is a free float-adjusted market capitalization index designed to measure developed market equity performance in Europe.

MSCI Japan Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of the developed markets in Japan.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

Russell 2500 Index measures the performance of the small- to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000 Index.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

Indexes shown for illustrative purposes only. It is not possible to invest directly in an index.

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