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Market Review
Fourth Quarter 2017

The fourth quarter put the exclamation point on a strong financial year.

The year started on the heels of the highly improbable election of Donald Trump, which catalyzed the largest post-election rally in history. And, the stock market never looked back.

The S&P 500 returned 6.6% in the quarter and 21.8% for the full year. The Russell 2000 index lagged, but was still up 3.3% and 14.7%, respectively. The strong performance also extended overseas with broad-based Developed and Emerging Market benchmarks up 16% and 31% in local currency terms. Although there was some reversion in the fourth quarter, growth outperformed value on both ends of the market cap spectrum, and across geographic regions.

In many ways, this result is about as steady as it gets in financial markets. The S&P 500 finished in positive territory each month on a total return basis. Market volatility, whether measured by the implied volatility of index options (VIX), or by the frequency and magnitude of pullbacks, remained exceedingly low. But, it doesn't capture the full story for investors during the period – Washington was tumultuous, the country divided, and geopolitics tense. The drivers of performance were also very fluid over time.

The first phase of the rally was, of course, borne out of the post-election (financial) euphoria. The President's domestic agenda, which focused on tax reform, infrastructure investment, and the deregulation of the government and the economy, resulted in a sharp cyclical rotation into commodity, industrial, and financial stocks that was deemed the "Trump Trade", and catalyzed a four-month, double-digit rally that started in November and extended well into the first quarter.

With markets up so much, so quickly, however, it didn't take long for investors to question the drivers of the ascent. The jolt came when it became clear just how hard it was going to be to repeal and replace Obamacare; the concern that it portended a difficult path for future legislation.

The surprise was that markets pivoted rather the panicked, which paved the way for the next phase of the advance. While gains were more muted, the S&P 500 and Russell 2000 continued to climb through the spring and summer, as investors returned to what worked in 2016, a very narrow group of expensive growth stocks. This was evident in large cap by the extreme outperformance of the FANG (Facebook, Amazon, Netflix, Google) stocks. In small cap, biotech led the market and gained over 20% between March and August compared with low-single-digit returns for the broader indices.

In September, the script changed again as different pieces fell into place to reignite the cyclical reflation trade. The sentiment started on the back of improved earnings growth and confident business outlooks. It was furthered by robust economic data, which included back-to-back quarters of 3% GDP growth and the best manufacturing surveys in over a decade. But, the biggest impetus for the final (reflationary) rotation was President Trump's initial tax reform outline and speech, which culminated in the passage of the Tax Cut and Jobs Act in December, providing the perfect encore to a year of huge gains.

Our experience in 2017 was that our portfolios muddled in the beginning of the period, and struggled during the middle months when the winners were few and far between and were very expensive growth stocks. We fared much better in the latter third of the year when the economic and profit recovery accelerated and the stock market rally broadened in scope. Health care was the year's biggest detractor to performance with biotech up over 50% in both the Russell 2000 and Russell 2000 Growth indices.

In this context, we are excited heading into 2018 that the combination of tax reform and economic recovery has helped to reconnect the market with profits. If the trend continues, we expect that valuation will become a much more important determinant of future performance as well. The risk is that it is too early to tell if the Tax Cut and Jobs Act can foster sustainable long-term growth, without overheating the economy, which is a delicate balancing act and makes an expensive (and complacent) market vulnerable.

Sources: *FactSet, Credit Suisse, GICS Sector Classification*

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Index Definition Sources: *Standard & Poor's; Russell Investments*

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