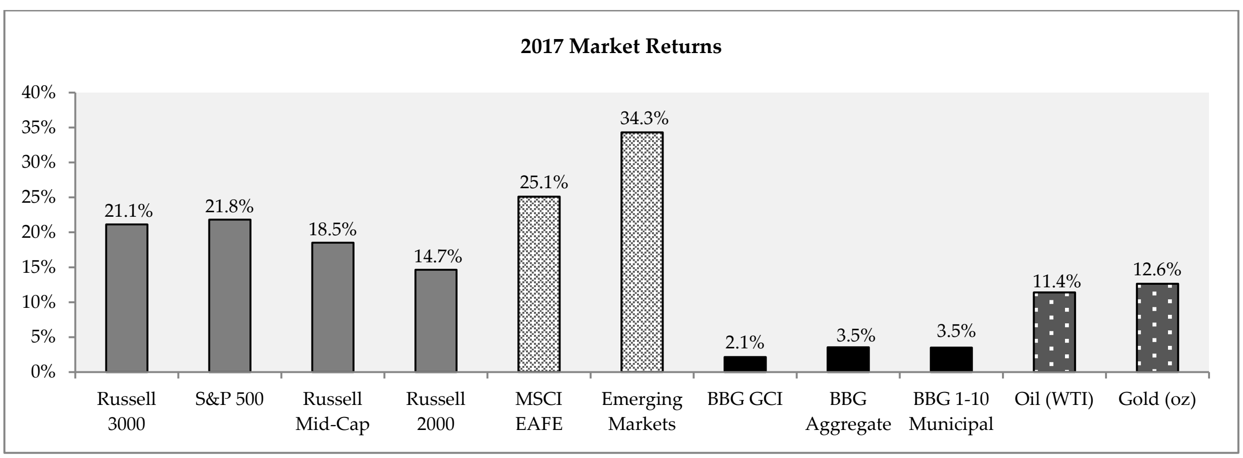
STERLING
CAPITAL

**Investment Review and Outlook**
**December 31, 2017**

***"If you want to grow old as a pilot, you've got to know when to push it, and when to back off".*** **Chuck Yeager, Brigadier General, U.S. Air Force.**

Investors who took the advice of General Yeager and *"pushed it"* in 2017 enjoyed an extremely profitable year. Markets around the world soared! Caution early in the year over the new administration quickly gave way to aggressive bullishness by summer. Investors' appetite for risk was fueled by global economic expansion, regulatory rollbacks, better than expected corporate profit growth, and steady Fed policy. Stronger than expected fundamentals and rising expectations of a pro-business bias in Washington ignited one of the broadest global market advances in history. Markets plowed through record highs at a pace that left investors with little time to celebrate before the next milestone was surpassed.

Every major market segment ended the year in positive territory. Large, mid, and small cap equities posted double digit gains, and all major fixed income indices delivered positive results. International stocks led global financial markets higher as developed and emerging markets broke their multi-year streak of underperformance relative to the U.S. Even commodity prices experienced a resurrection by breaking their downward spiral and posting solid gains. The chart below shows the magnitude and broad participation of the markets in 2017.




*Sources: Bloomberg, Factset*

Although market returns were very strong, the magnitude of gains is not what made the year extraordinary. In fact, the S&P 500's gain of over 21% does not even rank in the top 20 of best calendar year returns for the index since its creation in 1926. What makes 2017 a historically remarkable year is the breadth of market gains, and the incredibly smooth ride investors enjoyed throughout the year.

Last year's market advance was among the broadest in history as gains were shared across all asset classes. In fact, 2017 marked the first time in over thirty years that all global equity, fixed income, and commodity indices simultaneously posted positive results. Equity gains were broad as over 350 stocks in the S&P 500 outperformed the overall index. The index was pushed higher by a diverse group of sectors including financials, technology, materials, and health care. The only detractors were the relatively small energy, telecommunications, and real estate sectors.

However, it was the lack of price volatility that made 2017 a truly historic year. Despite global security threats, political brawling, policy uncertainty, and an endless supply of scandals investors maintained their focus on traditional market fundamentals. As a result, equity markets glided effortlessly higher against the headwinds of negative sentiment. The S&P 500 posted positive gains in every month – a streak that has not occurred since 1993. The persistent march higher resulted in more than 70 record closings for the Dow, S&P 500, and the NASDAQ. In addition, there were only eight trading days during the year where the daily change in the S&P exceeded 1%. The average over the past forty years is 65 days.

There remain many unresolved issues that investors will face in the new year. Market participants will confront uncertainty over the new tax code, a flattening yield curve, new leadership at the Fed, rowdy mid-term elections, and more global threats from adversaries such as North Korea. In addition, every year brings unanticipated threats and hurdles. Overall, we expect 2018 to be more challenging than last year. Success in the new year will require investors to pay close attention to General Yeager's advice to *"know when to push it, and when to back off"*.

## Economic Outlook

***"We realized that as the box got smaller, its influence got larger"*, Robert Noyce (1927 – 1990), Co-Founder of Intel Corporation.**

As the co-founder of Intel Corporation, Robert Noyce realized that being an integral part of a process made you invaluable to its success. Regardless of how large your share might be it is more important that you are connected in every way possible. Mr. Noyce made his comment at the start of the semiconductor industry in 1968; however, his words are directly relatable to the current global economy.

The U.S. share of the global economic pie has been shrinking for several decades. Trade policies, changing demographics, and advances in technology have helped push down the U.S.'s share from 38% of global GDP in 1980 to an estimated 25% in 2017. However, despite this decline the U.S. continues to be the largest and most significant driver of global economic prosperity. Through globalization the U.S. share of world GDP may be smaller yet our influence on global economic growth remains unsurpassed.

Gross Domestic Product is a measure of the total market value of final goods and services produced in an economy. This measure of economic clout fails to capture key drivers of future economic growth such as the power of innovation, access to capital markets, political stability, purchasing power, and availability of natural resources. Globalization has created an economic environment that integrates the strengths of the U.S. into every aspect of the global economy. In short, there would be no synchronized global growth without a strong and vibrant U.S. economy.

The U.S. economy continued to build momentum throughout 2017, and we see this accelerating in the new year. We are enjoying historically low borrowing costs in an environment of regulatory relief, low unemployment rates with modest inflation, and monetary policy that is following a measured path. In addition, new tax policies are expected to contribute additional fiscal stimulus to an already accelerating economy.

Our view is that the U.S. economy in 2018 will grow at a stronger pace than it has in over a decade. Annual GDP growth since 2007 has been a meager 1.5% - 2.0%. We believe expansion of 2.5%-3.0% in the new year is achievable - giving ample fuel to prolong the global synchronized expansion. Given this positive outlook for the U.S. economy we believe corporate profits will increase more rapidly than many investors are anticipating. These positive economic trends will offer a strong foundation for global capital markets in the new year.

Nevertheless, our economic optimism is balanced against the skepticism that unexpected events can occur, resulting in negative market reactions. For this reason we find it beneficial to challenge our outlook by considering what factors could alter our positive view for 2018.

## Three Possible Developments to Watch in 2018

***"You never run out of things that can go wrong"*, Edward A. Murphy, Aerospace Engineer & 'Murphy's Law' originator, (1918-1990)**

Although we have conviction in our economic and capital markets outlook, we realize that investing in today's environment is filled with uncertainty and potential pitfalls that can derail a perfectly plausible forecast. We have identified three events that could impact our market view.

### Tightening Labor Markets:

There is little debate that U.S. employment conditions are improving. The unemployment rate has fallen dramatically in the past two years, ending the year at 4.1% - its lowest level in over 17 years. Businesses, large and small, are finding it difficult to fill vacant positions. According to the Labor Department the number of unemployed per job opening is now at parity. This means that for every unfilled job there is an individual actively seeking employment.

With expectations that economic growth continues to improve in 2018 labor markets are expected to tighten further. Tight labor markets historically have led to wage growth and rising inflation. In the past 40 years when unemployment rates approach 4.0%, and GDP growth rises to 3.0%, average year-over-year wage growth gets pushed up to over 4.5%. In the current cycle, wage growth is taking a different course. Despite similar employment and growth metrics, current year-over-year wage growth remains flat at 2.5%. If strong growth causes a sharp acceleration in labor costs it could prompt more aggressive Fed policy as they attempt to slow inflationary pressures. If investors become concerned that inflation is on the horizon, and perceive that the Fed is playing 'catch up' by raising rates more aggressively than anticipated then the markets will be vulnerable to significant retrenchment.

Our view is that structural changes to the labor market and the economy are underway that should allow for tight labor markets and a growing economy to co-exist with modest wage inflation. These changes include demographics, technology, and rising productivity. However, it is always dangerous for investors to believe "things are different this time". Therefore, we will be watching the relationship between labor markets and wages closely to insure we are not left behind if the Fed begins to chase the inflation "rabbit".

### China Makes The News (Again):

It wasn't long ago that every economist and market pundit was babbling on about how China held the fate of the U.S. economy in its hands. Investors were told about China's growing consumer population, and massive infrastructure projects that were gobbling up global commodities at any cost. Investors were warned of the possible liquidation of trillions of dollars in U.S. Treasury debt that was being held by the People's Bank of China. China even became a central part of the 2016 presidential election when candidate Donald Trump positioned the U.S. as a victim of Chinese trade deals.

The Wall Street Journal recently compiled a list of the top ten economic stories of 2017. It is not surprising that the list contained the Republican tax bill, Janet Yellen's departure from the Fed, and the Bitcoin mania. Notably absent from the annual list of top stories was any reference to China. In contrast, the same list for 2015 and 2016 included six stories about the world's second largest economy.

The last two U.S. equity market corrections of greater than 10% were primarily driven by concerns over China. In the summer of 2015 Chinese economic officials reluctantly acknowledged that their growth rate was slowing. The ratcheting down of Chinese annual growth expectations from 10%-12% to 7%-9% had a rippling effect on U.S. markets. The S&P 500 dropped nearly 12% from early June into August, 2015. U.S. markets regained their losses late in the year; however, disappointing corporate earnings along with the news that China's GDP actually only grew 6.5% in 2015 sent U.S. equity markets down again by over 10% in early 2016.

After over a year of being out of the economic spotlight we believe China may resurface as an important influence on the global economy and financial markets in 2018. The economic guillotine China finds itself in involves the extraordinary amount of debt it has amassed over the past decade. The debt was used to fuel extensive infrastructure projects that included entire cities with uninhabited residential buildings. In 2010 China's debt-as-percentage of GDP was 90%. By the third quarter of 2017 debt had grown to over 200% of GDP. Similar levels of debt were experienced by Japan in the 1980's, Thailand in the late 1990's, and Spain in 2012. In each of these instances a debt crisis followed. However, China's situation could be more troublesome given the size of its economy and that the majority of debt is owned by state-sponsored banks.

The impact of the Chinese economy on U.S. financial markets is complex, making it difficult to assess precisely where to set our investment expectations. Our intention is to monitor closely how this develops.

**Complacency Creeps Into The Markets:**

It has been two years since equity markets have experienced a 10% correction, and over seven years since the last bear market decline of 20%. In fact, the market hasn't dropped by more than 3% from its high since the third quarter of 2016. The market's steady march higher is unprecedented in that it has come with practically no volatility. In fact, of the 248 trading days last year, 196 of them were positive for the S&P 500 – that equates to four up days per week!

Despite this equity "wonderland" of uninterrupted market gains accompanied by limited volatility there continues to be an ample amount of investor skepticism. Consumer confidence is rising but is far from the extremes experienced prior to other asset "bubbles" in the past. Rising geopolitical fears, daily doses of Washington drama, and legitimate concerns over how new economic policies will impact the markets has kept a tight lid on investor euphoria. There certainly does not seem to be another case of "irrational exuberance" on the horizon like Fed Chair Alan Greenspan warned the markets about in December, 1996.

Our view is that rampant skepticism and suspicion about the market's strength is a good sign that a bottomless slide in the market is not in the foreseeable future. Of course, we are not ruling out pullbacks, corrections, and rising volatility. Investors continue to climb the "wall of worry." This gives us comfort that future gains remain probable.

Despite investors' doubts about the current market we will be watching closely for signs of complacency. Should market participants shift their behavior towards a sense of entitlement and expectations of endless gains, we will view this as a serious warning sign. Complacency is difficult to measure. However, in the absence of objective data to help identify investor emotions we will be watching closely for signs of complacent behavior.

While we don't ascribe a high degree of risk that any of these events would unravel current economic momentum, it is important that we monitor closely what Edward Murphy warned against when he said there is "*always something that can go wrong*".

## Investment Strategy

***"Progress takes the courage to withstand an assault. You can't steal second base and keep your foot on first!"***
**Peter Lynch, Former Fidelity Magellan Asset Manager and Philanthropist.**

2017 was a historic year for the markets. Investors reaped tremendous rewards with limited risk. It is unlikely we experience a similar market at any time in the near future. Therefore, it is important that our New Year's resolutions include a downward adjustment in our return expectation to more normalized levels, and we brace for higher volatility. More modest returns with higher volatility in 2018 may be unsettling and feel like "an assault" at times. However, it is critical that we look forward, and not expect the same market experience as last year.

Our outlook for 2018 calls for accelerating global economic growth, rising corporate profits, and subdued inflation. These positive fundamentals will get an additional boost from tax cuts and predictable rate hikes by the Fed. This positive economic scenario should allow global equity markets to continue their climb higher. However, we believe being too *optimistic* in the current environment carries more risk than being too *pessimistic*. Therefore, we are keeping our economic enthusiasm well-grounded. Capital markets and economic fundamentals are strongly linked yet their paths often diverge over market cycles. Understanding these potential market dislocations is critical to establishing effective investment strategy. As we enter another year filled with uncertainty we continue to emphasize maintaining a strategy that focuses on long term objectives and broad diversification.

### U.S. Equities

We believe U.S. stocks will be direct beneficiaries of continued global economic growth. We expect market volatility to meaningfully increase relative to last year. To help mitigate portfolio volatility and maintain market exposure we continue to focus on diversification. Although we emphasize exposure across the capitalization spectrum, we find small and mid-cap stocks particularly attractive in the current environment.

Small and mid-sized companies stand to benefit the most from corporate tax reform. On average small companies pay taxes at a higher rate than large companies that are better positioned to take advantage of tax breaks. In fact, it is estimated that companies in the Russell 2000 pay an average effective tax rate of 34.3% versus their large cap counterparts that pay a much lower rate of 26.4%.

Although U.S. equity valuations appear to be approaching worrisome levels based on current earnings, corporate profit growth has exceeded analysts' estimates for the past several quarters. We expect this profit momentum to continue well into the new year. Despite our preference for small and mid-cap stocks we firmly believe diversification across the capitalization spectrum is more important now as market leadership shifts rapidly and volatility intensifies.

### International Markets

In 2017 our conviction level of international equity markets shifted to a more positive stance, and our conviction level continues to rise. Our positive view is driven by accelerating global growth, favorable monetary policy by global central banks, and attractive valuations relative to domestic equities. We believe these are the fundamental ingredients that will deliver strong relative performance over the next several quarters.

Diversification across regions is critical in order to reduce country-specific risk. We believe exposure to both developed and emerging markets will prove additive to portfolios. Broad-based global growth can benefit emerging markets more directly than many large, more developed economies. Emerging markets economies such as China, India, and Brazil are primarily export based; therefore, they benefit directly from increased trade driven by higher demand from developed nations.

**Fixed Income:**

As we enter 2018 our view on interest rates and fixed income markets remains unchanged. The improving U.S. economy with tightening labor markets, modest inflation, and synchronized global growth gives the Fed ample justification to continue liquidating their balance sheet by selling bonds. Ultimately the combination of the improving economy and the Fed's monetary rationing will lead to higher interest rates across the maturity spectrum. We are closely watching the shape of the yield curve as it continues to flatten. At the beginning of 2016 the spread between the ten-year and two-year Treasury bond stood at 127 basis points. At year-end the spread had dropped to 52 basis points. This type of yield curve movement often portends an economic slowdown. Although we do not believe an economic retrenchment is looming, we will be watching this key indicator closely.

Given our positive economic outlook, bond markets will face challenges in an environment of rising long yields accompanied by the Fed's policy of pushing short rates higher. Therefore, portfolio decisions regarding duration, credit selection, and yield curve positioning become extremely important. Our current strategy emphasizes corporate securities relative to Treasury and agency bonds in taxable portfolios. We remain positive on high quality municipal bonds, and believe current yields relative to taxable bonds are attractive. We are positioning portfolios short of benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. However, the upward move in interest rates will eventually provide more attractive cash flow to meet income needs.

As we close the books on 2017 we are very pleased with how financial markets have treated investors. However, we do not plan on letting strong markets accompanied by mild volatility lull us into a false sense of complacency. The new year will bring with it new challenges which will offer us additional opportunities. Our focus will be on discovering where these opportunities develop, and positioning portfolios to capture their benefits.