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A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

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As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. But, as wealth managers, it is our job to analyze the world around us and invest in the context of the short- and intermediate-term economic landscapes. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2018

1. U.S. stocks will deliver another positive year as tax rate cuts and economic growth boost corporate profits.
2. The Federal Reserve, under new leadership, will go slow, raising rates three times or less during 2018. The Fed's actions will result in a more flattened yield curve.
3. Bond yields will gradually move upward, resulting in positive, but modest returns for the benchmark Barclays Aggregate Index and high quality fixed income securities.
4. Low levels of unemployment and interest rates will continue to support the residential real estate market, with prices rising at single-digit rates at the national level.
5. The U.S. stock market will experience a correction, breaking a long streak of abnormally low volatility.
6. International/global equity will outperform domestic equity, albeit with higher levels of risk.
7. Small Cap stocks will have a good year, near or better than their historical averages, as smaller companies disproportionately benefit from the cut in corporate tax rates.
8. The tax-exempt bond supply may decrease next year if some plans floated under the House bill during tax reform talks are formally adopted, resulting in modest price increases amid continued demand.
9. Commodities will increase in value as the global economy picks up steam and Saudi Aramco gets ready for its record setting IPO.
10. Infrastructure stocks, supported by a confluence of positive factors, will outperform the market.

Beacon's Four Investment Themes for 2018

Beacon's 2018 Investment Themes echo our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. The bull market for U.S. stocks continues for the tenth consecutive year.
2. Capitalize on the synchronization of global economic growth.
3. Bonds will show their mettle during volatile periods in the equity market.
4. Be prepared for a return of volatility.

A Glance Back on the Year That Was

In a familiar refrain in the roughly nine years since the Great Recession ended, U.S. stocks and bonds experienced another positive year, at the time of this writing. Stocks sailed through the year with minimal volatility, with the S&P 500 up 18.6% in 2017 as the year comes to a close. The biggest intra-year drawdown was only 3%, the smallest drop since 1995. Bonds, despite some intra-year volatility and the announcement of the changing of the Fed Chairperson, increased roughly 3% for the calendar year.

Before we look ahead to 2018, it seems only fair to look back on our 10 forecasts for 2017. What did we get correct and where did we go wrong? In our view, five of our ten predictions were correct and two were partially correct. Three predictions were simply wrong. Let's start with our mistakes. We thought the U.S. Dollar would strengthen versus the Euro as the Federal Reserve gradually continued its monetary tightening program, while the European Central Bank (ECB) was still in the midst of easing. Although the Fed and ECB followed through on these plans, unexpected strength in the Euro region economy resulted in the Euro rising versus the U.S. Dollar. Stock price volatility was remarkably calm in 2017, with the Chicago Board of Options Exchange Volatility Index (VIX) falling from 14 at the beginning of the year to roughly 11 as we close the year. We thought the reparation of overseas cash would occur in 2017, but it appears to be delayed a year. Let's move on to what we got right in 2017.

As noted above, the stock market had a very strong year, closing in on a 20% gain for the calendar year. The Fed raised interest rates twice and is poised to raise rates again after its December 12-13th Federal Open Market Committee (FOMC) Meeting. Real estate had another good year, with the Case-Shiller Home Price Index increasing about 6% in 2017. Inflation has increased modestly, at a rate of about 2%, but less than its 3% historical average. Index funds and exchange traded funds (ETFs) continued their asset gathering momentum, gaining more inflows than actively managed funds in 2017.

In terms of our partially correct forecasts, we predicted that Financials, Healthcare, and Energy would do well, based on President Trump's proposed economic platform. The first two sectors did well, but Energy lagged. We also forecast that private real estate investments trusts (REITs) and floating rate bond funds would outperform fixed rate bond funds. REITs did outperform traditional bond indexes, such as the Barclays Aggregate, but floating rate funds lagged a bit. **Table 1** provides a summary scorecard for our 2017 forecasts.

Table 1: Review of Beacon's 2017 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
Stock returns to exceed 10%	Correct	The S&P 500 is up roughly 18.6% YTD as of this writing
Fed to raise rates at least twice in 2017	Correct	The Fed raised short-term rates 3 times in 2017 *
Repatriation of cash spurs buyback ETFs	Incorrect	Repatriation reform was pushed back to 2018
Real estate prices to rise single digits	Correct	Case-Shiller Home Price Index increased about 6.15%
Dollar to strengthen vs. Euro and reach parity	Incorrect	The Euro increased vs. the U.S. Dollar
Volatility to Increase	Incorrect	VIX fell from 14 to 10 over the course of the year.
Financials, Healthcare, Energy to outperform	Partially Correct	Financials and Healthcare did well, Energy lagged
Private REITs and Floating Rate to beat Fixed	Partially Correct	Private REITs beat Fixed, but Floating Rate lagged
Inflation to increase > 2%, but less than 3%	Correct	The CPI increased about 2% in 2017
Flows into passive funds to exceed active	Correct	Passive flows increased while active flows decreased

** Assumes rates are raised after the December 12-13, 2017 Federal Open Market Committee meeting.*

A Closer Look at Beacon's Ten Investment Forecasts for 2018

There is an element of risk in offering predictions, since the future is uncertain. We can state with confidence that some forecasts we offer for 2018 are likely to be correct, some incorrect and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2018 are neither on our list, nor on anyone else's. For example, few strategists at the start of the year forecasted that bitcoin would reach a level of nearly $17,000 per coin, that North Korea would test a massive nuclear bomb, or that Saudi Arabia would conduct a radical shakeup of its government. It is often the events that few investment strategists are talking about that result in the most extreme market movements. As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2018.

1. **U.S. stocks will deliver another positive year as tax rate cuts and economic growth boost corporate profits.**

   Consensus analyst estimates project nominal earnings growth of roughly 10% for the S&P 500 in 2018, although it is not clear to what extent the consensus has priced in the projected corporate tax rate cuts. Absent other information, we would readily forecast another double-digit rate return for the S&P 500 in 2018. However, we do have other information that may temper return expectations. Interest rates are expected to rise, especially at the short-term segment of the yield curve. Rising interest rates usually temper stock returns. Valuations are on the expensive side, relative to most historical metrics, therefore multiple expansion seems unlikely. Volatility also has a high likelihood of rising (see Forecast 5 and Theme 4 for details). These factors suggest to us that another double-digit gain for the S&P 500 may be challenging, unless "bubble psychology" takes hold of investors, resulting in a "melt-up" similar to what occurred in the late 1990s. Nevertheless, when 2018 eventually comes to a close, we expect to see stocks in the black for the tenth consecutive year, with a mid-single digit or better return.

2. **The Federal Reserve, under new leadership, will go slow, raising rates three times or less during 2018. The Fed's actions will result in a more flattened yield curve.**

   Jerome Powell is in the process of taking the reins as Fed Chairperson from Janet Yellen. In our view, Powell will not want to hamper the current solid economic recovery by raising rates too quickly or by shrinking the balance sheet too aggressively. Powell is also aware that a flat to inverted yield curve usually negatively impacts bank profits and increases the likelihood of a recession. Therefore, in our view, the Fed will raise rates 0.25% on three or fewer occasions in 2018, a slower pace than most conventional estimates and the Fed's own "dot plot." We believe the absence of surging inflation and low interest rates abroad will temper the rise in long-term interest rates, resulting in a more flattened yield curve in 2018.

3. **Bond yields will gradually move upward, resulting in positive, but modest returns for the benchmark Barclays Aggregate Index and high quality fixed income securities.**

   We believe that healthy GDP growth of roughly 3%, rising corporate profits, a tax rate cut for most individuals, and a gradually tightening Fed will also spill over to long-term rates, resulting in a gradual rise in rates over the course of the year. However, low interest rates in much of western Europe and Japan still make long-term U.S. Treasuries a fairly attractive investment. We believe inflation will remain somewhat contained until we see evidence of a sharp rise in wages or commodity prices – neither of which are here yet. Hence, we see the benchmark 10-Year Treasury staying in a range of 2.25% - 3.25% for most of 2018, relative to its current yield of 2.4%. This should net out to positive returns for the widely followed Barclays Aggregate Bond Index, although we think it will be extremely challenging for bonds to achieve even mid-single digit returns. Incremental returns may be achieved by purchasing high quality bonds, effectively capturing extra yield without materially increasing interest rate risk. We view bonds in this environment as part of a diversified portfolio providing income and important downside protection during the inevitable drops in equity prices.

4. **Low levels of unemployment and interest rates will continue to support the residential real estate market, with prices rising at single-digit rates at the national level.**

The underpinnings remain in place for a good real estate market at the national level. Namely, low levels of unemployment (currently at 4.1%), relatively low levels of interest rates, loosened bank regulations, a strong economy, and stock prices at all-time highs. This confluence of factors has also resulted in extremely high levels of consumer confidence. The real estate market is bound to be a beneficiary of this goodwill, with prices poised to rise at the national level. Nevertheless, we expect to see price pressures in some expensive properties (i.e., high six figures and up) in high tax regions as many tax breaks (i.e. mortgage interest, state and local taxes, etc.) seems likely to be curtailed, or disappear, under the Republican tax cut plan.

5. **The U.S. stock market will experience a correction, breaking a long streak of abnormally low volatility.**

   Volatility has been abnormally low. As noted earlier, VIX is ending the year at a level of around 11, well below its historical average of 18-20. Furthermore, the biggest peak to trough drop in the S&P 500 in 2017 was only 3%, the mildest drop in equities since 1995. Investors often look in the rearview mirror when making investment decisions, extrapolating low risk in the past into low risk in the future. This flawed line of thinking often leads to excessive risk taking which often ultimately leads to excesses and a sharp drop in stock prices. Although the actual cause of a correction is difficult to pinpoint, we believe the usual suspects apply (i.e., North Korea, Middle East, China debt crisis or devaluation, Trump investigation/impeachment issues, Euro disintegration risk). However, corrections are usually short-lived and may in fact be a buying opportunity for opportunistic clients. Market volatility also often reminds us of the valuable role fixed income securities play in diversified portfolios.

6. **International/global equity will outperform domestic equity, albeit with higher levels of risk.**

   In many respects the U.S. emerged from the Great Recession faster and better than most other nations around the world. A mix of aggressive monetary policy and corporate innovations, led especially by the U.S. Technology sector, resulted in continued economic growth and nine consecutive years of U.S. stock market gains. The global economy appears to be in a period of synchronized economic growth, with international stocks playing "catch up" to their U.S. brethren. Although foreign stock markets are not homogenous, most are starting from lower valuation levels than U.S. stocks and their central banks are in more accommodative modes than the Fed. We think this creates a recipe for attractive returns for international/global stocks. However, we are mindful that the most of the risks in the world, as noted in Forecast 5, appear overseas. Hence, investors in international stocks must have the stomach for higher levels of volatility.

7. **Small Cap stocks will have a good year, near or better than their historical averages, as smaller companies disproportionately benefit from the cut in corporate tax rates.**

   Small cap stocks have lagged large cap stocks significantly in 2017, but they are mostly domestic in nature and will benefit more from the corporate tax rate cuts at the margin. It is also easier for firms to grow from a smaller base. We think this mix of factors and a strong economy creates an attractive backdrop for small cap stocks, enabling them to roughly meet or exceed their long-term average returns in 2018.

8. **The tax-exempt bond supply may decrease next year if some plans floated under the House bill during tax reform talks are formally adopted, resulting in modest price increases amid continued demand.**

   We believe the tax-exempt bond supply will decrease in 2018 if some plans floated under the House bill during tax reform talks are adopted. Specifically, the tax-exempt financing of certain kinds of municipal bonds known as private activity bonds (PAB's) would be eliminated (i.e., bonds issued to build sports stadiums, affordable housing, hospitals and other types of projects) in addition to eliminating advanced refunding bonds. The tax exemption on all other types of municipal bonds would remain in place and we expect demand to be robust next year, especially for bonds in high tax states such as NJ, CT, NY and CA. Investors in those states may look for a tax break on the interest income that municipals provide, as an offset to elimination of the state and local tax deduction as well as a cap on property tax deductions should those tax reform plans be passed.

9. **Commodities will increase in value as the global economy picks up steam and Saudi Aramco gets ready for its record setting IPO.**

   Commodities usually pick up in price as economic growth increases. GDP for the last 3 quarters of 2017 is poised to be at least 3% and we expect similar numbers in 2018, or better, as tax rate cuts kick in. Saudi Aramco is likely to complete its IPO in the second half of 2018, as Saudi Arabia looks to transform its economy from one based mostly on petroleum. This IPO may value Saudi Aramco at a record setting $2 trillion. To place this enormous number in perspective, the current most valuable stock in the world is Apple, at roughly $880 billion. We believe the Saudi government, and the rest of OPEC, will be supportive of a further rise in oil and other commodity prices. However, commodity prices are usually priced in dollars. We do not see a surging U.S. dollar in 2018, but if it materialized, it may offset much of the potential rise in commodity prices. In short, global growth is usually good for commodity prices.

10. **Infrastructure stocks, supported by a confluence of positive factors, will outperform the market.**

    The rebuilding of hurricane ravaged areas in Texas, Florida, Puerto Rico, and other regions, will be a positive for broadly defined infrastructure stocks and funds. In this category, we would include real estate, homebuilding, and materials firms. Although Republicans may not have enough money to engage in massive infrastructure spending, there is some support on both sides of the political isle to move incrementally in this direction, providing a long overdue facelift to many bridges, roads, and tunnels across the country. Good stock/fund selection in targeted in the broadly defined infrastructure category may pay dividends to investors in 2018.

Beacon's Four Strategic Wealth Management Themes for 2018

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2018, along with specific investments to implement them. Some of our recommended investments will apply to all clients, but since our financial plans are custom tailored, not all investments may apply to your particular situation.

1. **The bull market for U.S stocks continues for the tenth consecutive year.**

   There is a well-known stock market expression that "bull markets do not die because of old age." We tend to agree with this statement. Although the current bull market is the second longest on record, surpassed by only the one that resulted in the Internet Bubble, we still think it still has some life left. Stocks should get another boost from a strong economy and the round of corporate and individual tax rate cuts scheduled to be implemented in 2018. We would become more cautious on stocks if there were strong signs of an impending recession or if the yield curve became inverted – neither of which we see on the horizon.

2. **Capitalize on the synchronization of global economic growth.**

   It has been almost a decade since the Great Recession has officially ended, but the recovery has been anything but swift, emotionally and financially, especially for many international nations. However, for the past year or so the global economy has been in greater positive synchronization than at any other time in the past decade. We believe the good times will continue to roll in 2018 for the global economy. Accordingly, we suggest investors think globally in the construction of their portfolios. The U.S. constitutes less than 5% of the world's population and less than 25% of its GDP. We also agree with the quote from renowned global investor, John Templeton: "If you search worldwide, you will find more bargains and better bargains than by studying only one nation." Accordingly, we think taking a global approach to portfolio construction is the right thing to do for 2018 and beyond.

3. **Bonds will show their mettle during volatile periods in the equity market.**

   Investors have often wondered why they should hold bonds that pay low single-digit yields, especially during strong bull market periods for stocks. Of course, the answer is no one knows with certainty when the current bull market will end. Furthermore, the income provided by investment grade bonds is dependable. You can plan on it for important expenses. Investment grade bonds also act as important diversifiers in portfolios, often holding value during sharp drops in stock prices. In fact, the stability offered by investment grade bonds provides many investors with the courage to remain committed to stocks when they experience inevitable corrections.

4. **Be prepared for a return of volatility.**

   Stocks often provide attractive long-term returns since they have fairly high levels of risk. First, stockholders are paid, both with dividends and earnings, only after bondholders have been paid in full. Beneath the surface of the stock market averages are fierce battles waged between firms for market share and growth. Once venerable companies, such as Kodak, Sears, and IBM, have often found themselves in the corporate dustbin, while new titans, such as Google, Facebook, and Alibaba have emerged. Volatility also comes from macro sources, perhaps with the threat of nuclear war with North Korea being among the most ominous current risks. Risk is an inevitable part of the financial markets and by most historical measures, has been far too low recently. The good times cannot last forever. In our view, since it is impossible to predict with certainty the source of future losses, constructing a well-diversified portfolio is the best approach to balancing the ever present risks with the prospect of attractive returns. And this is the path that we at Beacon prefer to take, no matter how bullish or bearish our forecasts may be.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day.