Bring on 2018!

As the New Year is once again upon us, we would like to take a moment to reflect on 2017 and tell you a little bit about what's in store for 2018.

Last year was another milestone year for Trust Point. We passed the $4 billion mark in assets under management. Strong performance contributed, but our success was really due to you. We hit new highs for client retention, client additions, and referrals. Those referrals, above all, represent a true measure of your satisfaction. We appreciate you sharing your experiences with friends and family. We always have time to help those you care about. You don't need to keep us a secret!

Our success allows us to continue to expand our capacity to serve you. Our third full-service office will open in February in Eau Claire, Wis. The new office will serve our existing clients in that area and also allow us to offer our services to new clients, including individuals, companies, and nonprofits.

We also will unveil a new website in coming weeks. The redesigned site will offer access to even more of our resources and insights. In addition, Trust Point Magazine, our periodic newsletters, Charts n' Chatter sessions, and email bulletins all will expand this year to provide relevant, timely communication that helps you plan your financial future.

This will be our 105th year in business--a milestone that is rare in the financial industry and a reason to celebrate! Stay tuned for news about events and activities throughout the year.

The outlook is bright for 2018, and we are already off to a very strong start. We appreciate your continued trust and confidence. Thank you for your business.

"Strong performance contributed, but our success was really due to you."

MarketPoint

Fourth Quarter 2017 | Issue No. 20

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Equity Market Update
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An Economic & Market Commentary from Trust Point

An Economic and Market Update from Trust Point

Both absolute and relative performance of our modeled portfolios were very strong in 2017. We remain positive on equities, international stocks, and credit markets. Our modeled portfolios remain positioned to perform best in an environment of stable-to-rising global economic growth coupled with rising inflation and interest rates.

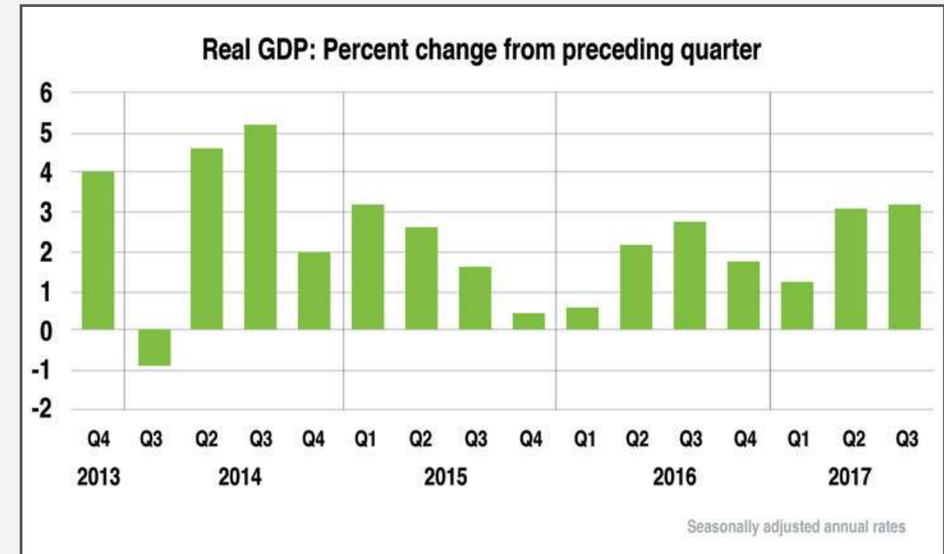
Global Economy Is Doing Very Well

For more than a year now, we have been experiencing a global, synchronized economic expansion. Growth in the U.S., Europe, Japan, and China has been solid in 2017. At the same time, expectations for 2018 and 2019 growth were also being revised higher throughout 2017. In the U.S., gross domestic product exceeded 3% in the second and third quarters, with growth in excess of 3% also expected in the final quarter of the year (Chart 1). Looking forward, the recently approved U.S. tax reform should continue to support growth and confidence. Overseas, the expansion in the Eurozone is increasingly broad-based, with strong performance from both the domestic and export markets. In Japan, business confidence and profits are rising. The Chinese economy has lost some momentum of late, as the immediate priorities are to reduce excess industrial capacity, cut leverage, and manage the frothy real-estate market. However, the slowdown will not be enough to derail the global economic expansion. Barring unpredictable events or shocks to the system, the known potential threats to this economic expansion appear well understood and historically modest. For the first time since the 2008-09 credit crisis, the world economy is doing very well indeed.

KEY ECONOMIC DATA	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Dec	92.1	93.1	102.2
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Dec	59.7	60.8	54.5
ISM Non-Manufacturing (>50 = Expansion)	Dec	55.9	59.8	56.6
Non-Farm Payrolls	Dec	148K	38K	155K
Unemployment Rate	Dec	4.1%	4.2%	4.7%
CPI Ex-Food & Energy (yoy)	Nov	1.7%	1.7%	2.1%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Dec	54.5	53.3	52.7
JP Morgan Global Services Index (>50 = Expansion)	Dec	53.9	53.8	53.3

Source: Bloomberg

Chart 1: Strong U.S. Growth In Recent Quarters

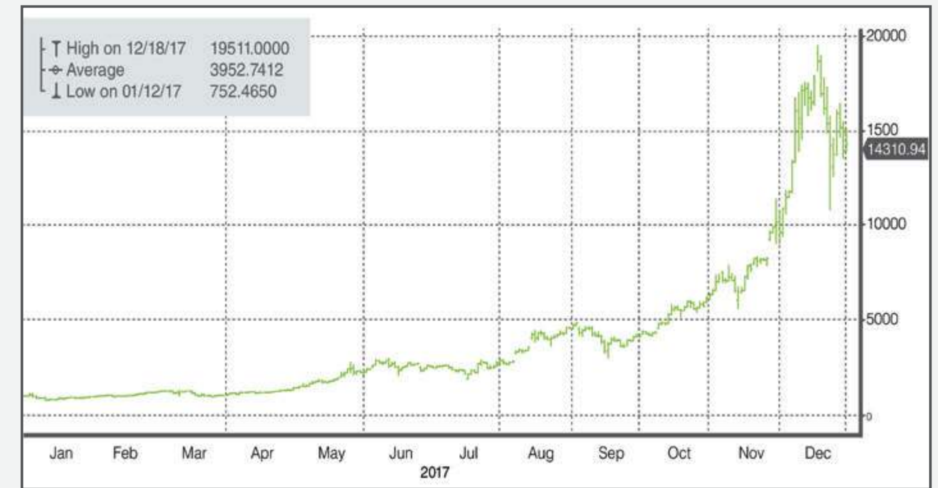


Source: U.S. Bureau of Economic Analysis

Interest in Bitcoin? Not Us

One sign that a market cycle is getting extended is the formation of irrational bubbles. In the late '90s, it was the bubble in internet and telecomm stocks that eventually led equity markets lower. In 2007-2008, it was housing. Today, signs of bubbles are hard to find in traditional asset classes. Bitcoin and the hundreds of other cryptocurrencies probably qualify as manic speculation candidates (Chart 2) but are unlikely to shake up the foundations of the U.S. or global markets. Investors interested in buying cryptocurrencies (we are not among those) should be aware that they are extremely volatile, are not a form of legal tender as they lack the backing of central banks, are unregulated, do not pay dividends or interest, don't lend themselves to fundamental valuation analysis, have low barriers to entry, and are increasingly subject to potential government intervention and regulation as they have often been associated with criminal activities.

Chart 2: Bitcoin: A Manic Speculation Candidate

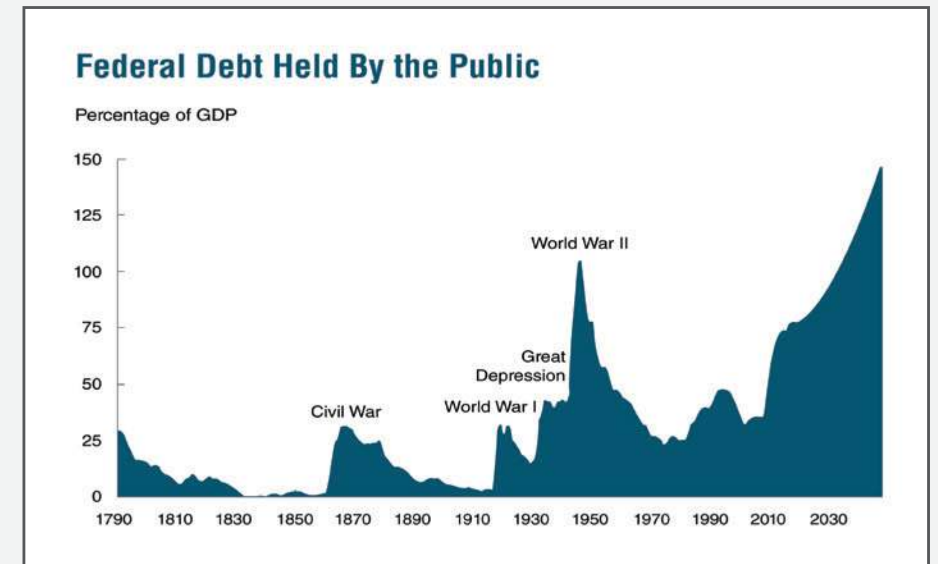


Source: Bloomberg

U.S. Tax Reform: Good but Not Perfect

"It's the economy, stupid," as campaign strategist James Carville put it in the early '90s. Most of the time, that is indeed what matters to most investors. In 2017, however, politics was also very much on investors' radar. There is no doubt that significant energy was spent in the first half of 2017 on trying to repeal and replace the Affordable Care Act. The second half, however, was a different story, as deregulation efforts and the passage of a major piece of tax legislation grabbed investors' attention. By slashing taxes for both individuals and corporations, the new legislation will boost after-tax earnings and promote domestic production by spurring capital spending, consumer spending, and hiring. By our analysis, the overall economic impact of the new tax law could add 0.1% to 0.3% to U.S. GDP in 2018 and 2019. However, since the output and unemployment gaps already have been effectively eliminated in the U.S., higher inflation and interest rates may be byproducts of this new legislation. Unfortunately, the tax reform doesn't do much to help solve long-term issues related to the federal debt level (Chart 3), wealth inequality, or unsustainable entitlement programs. In politics these days, however, constraints matter a lot more than preferences. Given the internal constraints the Republicans were facing, that was probably all they could do for now.

Chart 3: Grow the Economy or the Federal Debt?



Source: Congressional Budget Office

An Equity Market Update from Trust Point

The fourth quarter was yet another good quarter for global equities. The MSCI EAFE index was up 4.2%, while the S&P 500 increased 6.6%. Trust Point continues to believe that an overweight allocation to equities is appropriate given synchronized global growth and suppressed bond yields. International equities currently provide better opportunities than domestic equities, as they are being supported by lower valuations and solid expectations for earnings growth.

Equities Still Less Expensive Than Fixed Income, But Cheaper Overseas

Entering 2018, we remain overweight equities relative to fixed income in client portfolios. This risk-on stance is built upon the belief that the synchronized global growth environment will continue for at least the next 6-12 months; with bond yields continuing to be depressed, equities should remain inexpensive relative to fixed income. Valuations in the U.S., however, have become more stretched, though certainly not at bubble levels seen in 2000-2001. On the other hand, overseas regions including Europe, Japan, and Emerging Markets are seeing an improvement in corporate earnings growth consistent with the improvement being experienced in the U.S (see left side of Chart 4), but at lower valuations (see right chart of Chart 4). The Trust Point investment team has prudently lowered allocations to U.S. equities over the last several months while reallocating those dollars to overseas markets, particularly the Eurozone. Our overweight position to equities is intended to take advantage of what we foresee as a resilient bull market for the next six to 12 months.

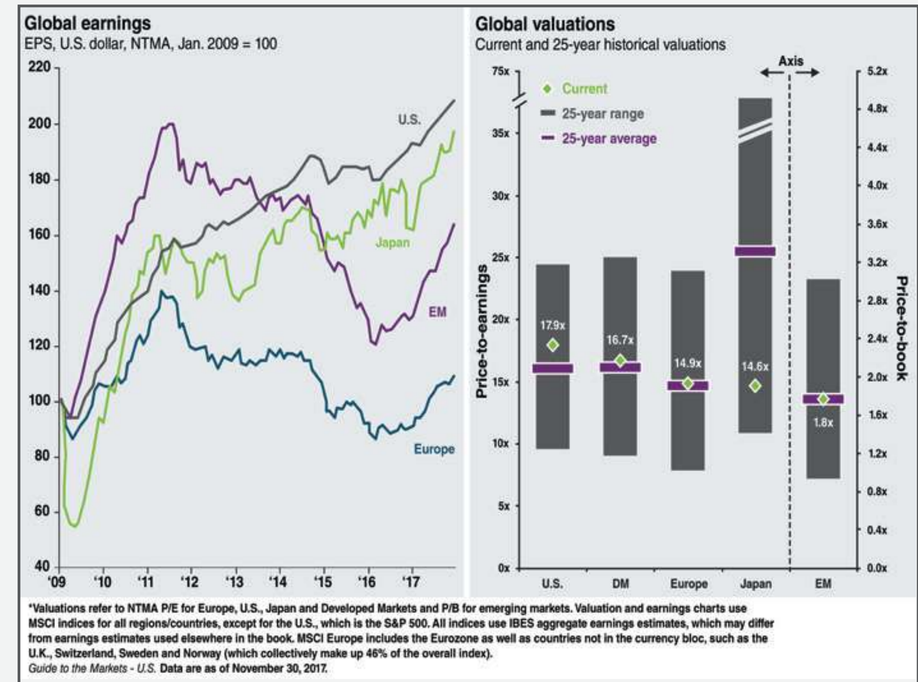
EQUITY BENCHMARK TABLE

US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 years Ago	5 Years Ago
S&P 500	2,674	2,519	2,239	2,044	1,426
Dow Jones Industrial Average	24,719	22,405	19,763	17,425	13,104
NASDAQ	6,903	6,496	5,383	5,007	3,020

Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	7.9%	30.2%	30.2%	13.8%	17.3%
US Large Cap Value	5.3%	13.7%	13.7%	8.7%	14.0%
US Mid Cap Growth	6.8%	25.3%	25.3%	10.3%	15.3%
US Mid Cap Value	5.5%	13.3%	13.3%	9.0%	14.7%
Us Small Cap Growth	4.6%	22.2%	22.2%	10.3%	15.2%
US Small Cap Value	2.0%	7.8%	7.8%	9.5%	13.0%
International Large Cap Developed (US Dollar)	4.2%	25.0%	25.0%	7.8%	7.9%
International Small/Mid Cap Developed (US Dollar)	6.1%	33.0%	33.0%	14.2%	12.9%
Emerging Market (US Dollar)	7.4%	37.3%	37.3%	9.1%	4.3%

Source: Bloomberg, Morningstar

Chart 4: International Equities Earnings Growth Consistent with U.S., but at Lower Valuations

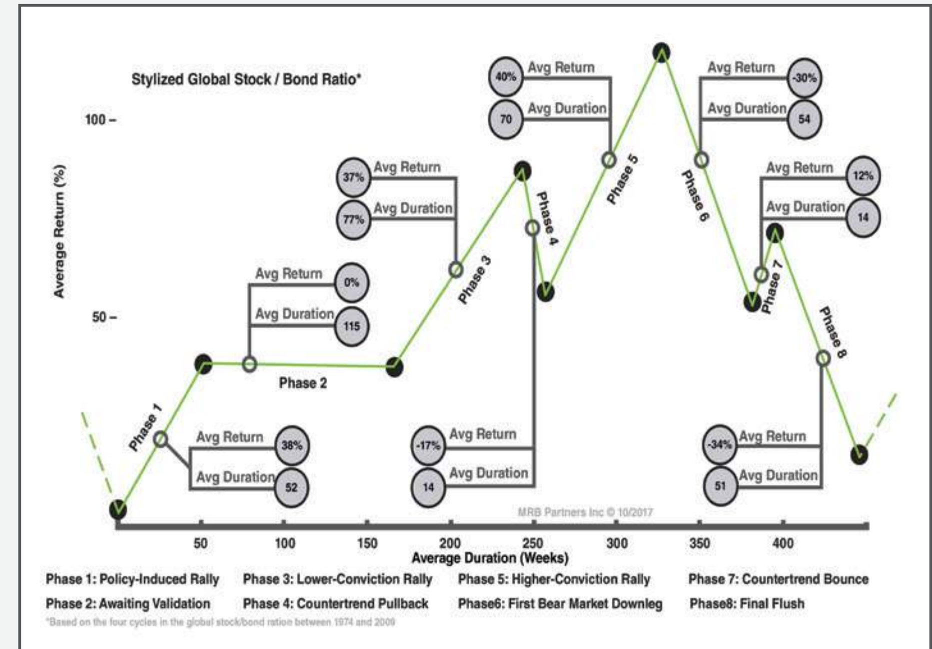


Source: FactSet, MSCI, Thomson Reuters, Standard & Poor's, J.P. Morgan Asset Management

Advanced Stages of the Investment Cycle

Since the recession of 2008-2009, global equity markets have seen sizable returns driven by extended rallies with only minor pullbacks. Our models and indicators suggest we are currently in Phase 5 of the market cycle (Chart 5), historically the phase with the highest average returns for stocks relative to bonds. After overbought conditions were unwound in Phase 4 (period from mid-2014 to mid-2016), and policymakers reaffirmed their reflationary commitment, phase 5 was able to start in mid-2016. Phase 5 is typically associated with strong economic fundamentals, lower spare capacity, and the beginning of tightening cycle by central banks. Phase 5 is also typically driven by companies generating strong revenue and earnings growth, which has been the case with market-leading stocks such as Alphabet, Amazon, Apple, Facebook, and Netflix. We caution that short-term market volatility and shallow corrections can happen at any time, for any reason, and without warning. At this point, however, we still are not seeing the catalysts for Phase 6 yet. Historically, recessions have led to more significant underperformance from stocks relative to bonds (Phases 6 to 8). We currently are seeing no signs of recessions in any of our indicators and models, domestically or globally.

Chart 5: Global Investment Cycle

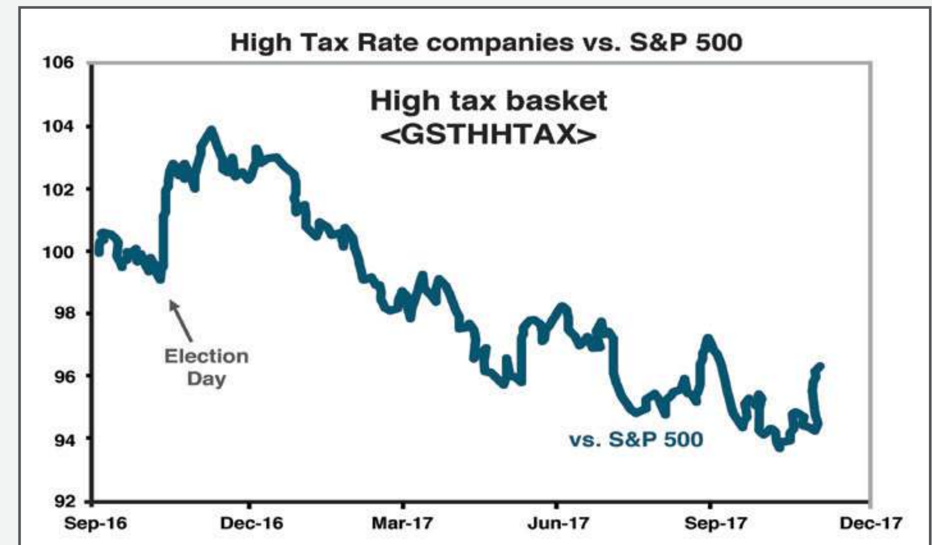


Source: MRB Partners

The Tax Cuts and Job Act Bill Now Signed, Which Equities Stand to Benefit?

The statutory U.S. corporate tax rate will drop to 21% from 35% with enactment of the Tax Cuts and Job Act bill. We believe that smaller-cap equities stand to benefit more than large-cap equities. Smaller companies generate less of their revenue and earnings overseas, where tax rates already are considerably lower. Smaller companies also lack the comprehensive accounting departments that give larger companies the resources to take advantage of tax loopholes. As for equity sectors, those such as Consumer Discretionary, Consumer Staples, Industrials, Telecom, and Utilities stand to benefit the most from a lower tax rate, since they tend to generate more of their revenue and earnings domestically. The question for investors, though, is: Are tax cuts already priced into the markets? We would argue they are not (Chart 6), as a "high tax basket index" designed by Goldman Sachs has underperformed the S&P 500 in 2017, implying there is still room for these stocks to move higher.

Chart 6: Tax Cuts Largely Not Reflected in Stock Prices Yet



Source: Goldman Sachs

A Fixed Income Market Update from Trust Point

Upward pressure on bond yields was sustained throughout the fourth quarter by increasing probabilities of tax reform and a December Fed Funds rate hike. High-quality bonds struggled while a strong backdrop of global growth allowed credit-sensitive bonds to continue to rally.

Is the Yield Curve Sending a Message?

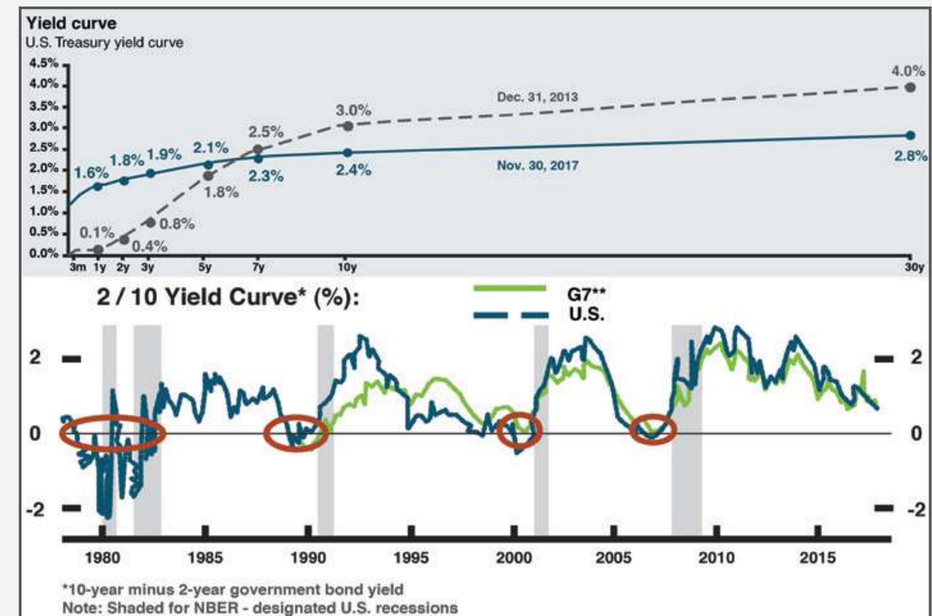
In December, investors could pick up a paltry half-percent in additional yield if they bought a 10-year treasury versus a two-year treasury. This small difference in yield between short and long-term bonds represents a flatter yield curve (Chart 7, top panel). Short-term rates (more sensitive to Fed policy) have gradually risen above zero as the Fed has continued to raise the Fed Funds rate, while longer-term rates (more tied to economic growth and inflation expectations) have remained somewhat anchored. In fact, this yield differential has shrunk to the lowest level since the last recession (Chart 7, bottom panel). This causes some concern, as the difference between short and long-term yields tends to get smaller when the economy reaches the later stages of an expansion. In our opinion, it is too early to worry about the curve flattening. The Fed is certainly raising short-term rates, but at a much slower pace than in the past and from a much lower starting point (zero). In addition, short-term rates and Fed policy rates are still low enough to promote business and consumer lending, which leads to economic expansion. Finally, we believe that longer-term yields have so far largely ignored stronger growth and early signs of intensifying inflationary pressures. As a result, we expect longer-term yields to move higher, resulting in a period of steepening yield curve over the next six to 12 months.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	1.4%	1.0%	0.5%	0.2%	0.0%
2 Yr US Treasury	1.9%	1.5%	1.2%	1.1%	0.2%
10 Yr US Treasury	2.4%	2.3%	2.4%	2.3%	1.8%
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-0.4%	2.2%	2.2%	1.7%	1.3%
US Treasury Inflation Protected Sec.	1.3%	3.0%	3.0%	2.1%	0.1%
US Mortgages	0.2%	2.5%	2.5%	1.9%	2.0%
US Short-Intermediate T/E Munis	-0.8%	2.9%	2.9%	1.6%	1.8%
US Investment Grade Corporates	1.2%	6.4%	6.4%	3.9%	3.5%
US Senior Bank Loans	1.1%	4.1%	4.1%	4.4%	4.0%
US High Yield	0.4%	7.5%	7.5%	6.4%	5.8%
US Convertibles	1.6%	13.7%	13.7%	6.8%	10.7%
Int'l Bonds Ex-US (Hedged)	1.2%	2.0%	2.0%	3.0%	4.0%
Int'l Bonds (Unhedged)	1.1%	7.4%	7.4%	2.0%	0.8%
Emerging Market Debt (US Dollar)	0.5%	9.3%	9.3%	6.8%	3.8%

Source: Bloomberg, Morningstar

Chart 7: Yield Curve Has Flattened To Pre-Recession Levels

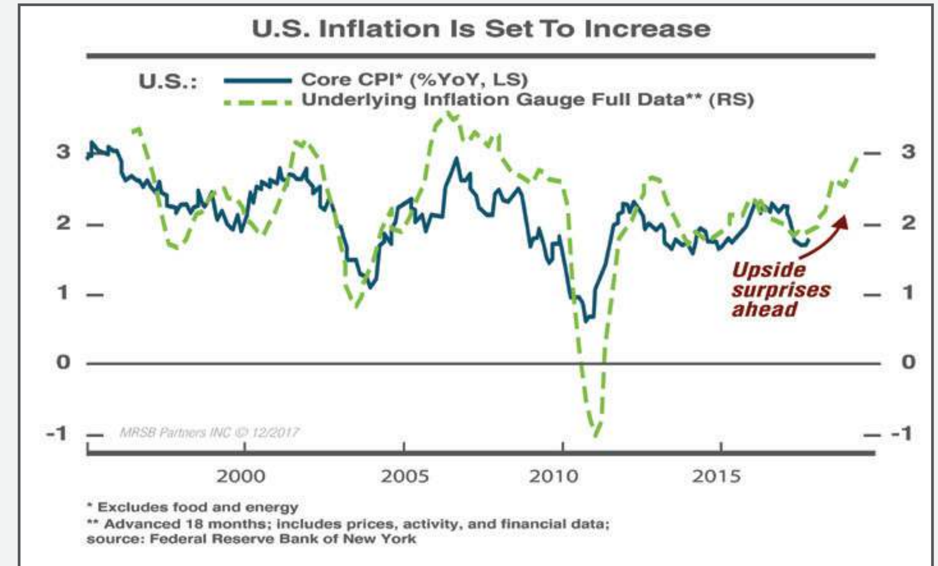


Source: JP Morgan Asset Management; MRB Partners

Bet on Higher Inflation

A key to the direction of interest rates and the yield curve referenced on the previous page is going to be the materialization of inflation, or lack thereof. Fed chair Janet Yellen, along with the most influential central banks on the planet, has been somewhat confused by the lack of inflation in the system. Historically, low unemployment rates lead to employees demanding higher wages as good workers become harder to find. Producers raise prices to offset higher wages, and the higher prices of goods are supported by increased demand from workers who are earning more. It becomes a self-fulfilling cycle that typically leads to an increase in overall inflation. With the current U.S.unemployment rate at the lowest level since 2000 and various measures of growth at post-recession highs, we think the fundamentals point to slowly rising inflation in 2018. When inflation expectations eventually pick up, longer-term interest rates will rise to compensate investors for the risk of potential loss of future purchasing power. Numerous models based on prices, economic activity, and financial data are currently forecasting higher inflation this year (Chart 8). If inflation is not higher by the middle of 2018, we will be surprised too.

Chart 8: Underlying Inflation Models Point To Higher Inflation

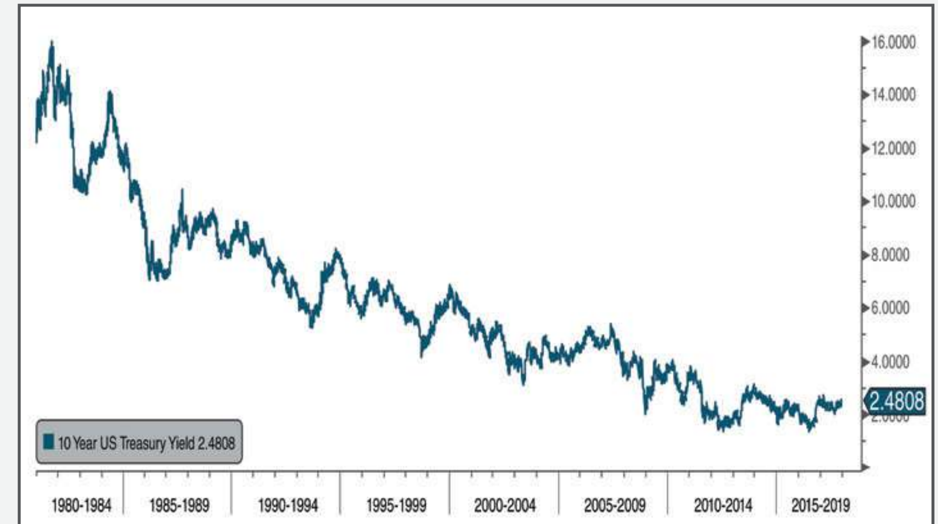


Source: MRB Partners

Where Do We Go From Here

Throughout 2017, we have favored asset classes that benefited from the strong backdrop of global growth, while remaining defensive in bonds where we see the biggest risks. We recognize that we are later in the economic cycle, but we think some of the same themes will play out again in 2018. Corporate health has improved in 2017, and default rates remain well below historical averages, which should lead to a continued trend of positive returns out of the credit markets. Interest-rate risk remains, which we eventually see coming from a pick-up in inflation and inflation expectations. Strong pro-growth policies, like tax reform, at a time when the unemployment rate is historically low and the economy is producing at full capacity, raises the risk of higher inflation and higher rates. This trend started to materialize in Q4 2017 and could gain some traction as we head into 2018. Inflation protection will remain a core position in our portfolios, along with limited exposure to bonds that are more susceptible to losses in an environment of rising interest rates. One final note: over the last few years, the 10-year treasury yield has failed to make lower lows, possibly forming a bottom as 2017 may have confirmed the end of the 30-year bull market for bonds.

Chart 9: 10-year Treasury 30 Year Bull Run May Be Over



Source: Bloomberg

MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment management team. The individuals contributing to Market Point are Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA, Brandon Hellenbrand, CFA®, Steve Brudos, Ryan Bergan and Evan Schnetzer. Please feel free to contact any team member with questions.

Pictured left to right: Ryan Bergan, Yan Arsenault, Randy Van Rooyen, Evan Schnetzer, Steve Brudos and Brandon Hellenbrand.

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