Wow, What a Year!

2017 is now in the history books, and it will be remembered for many things, including: record low volatility, strong earnings, increased global tension, the meteoric surge in Bitcoin’s price, and a strong stock market. The chart below shows the S&P 500’s 19.42% price move during 2017.

The S&P 500 rose in price by 6.12% in the fourth quarter alone. These impressive returns were driven by large-cap growth companies, specifically information technology, financial, and consumer discretionary companies.

Source: Standard & Poor’s 500, TD Ameritrade

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### 2017 Notable Statistics

- The S&P 500 (total return) rose every month for the first time on record, dating back to 1923.

- The S&P 500 has gone 282 trading days (as of December 31, 2017) without a 3% correction, the longest run on record.

- Growth outperformed value at every capitalization level (large, mid, and small) for the Russell benchmarks as well as the Standard and Poor's benchmarks.

- Large company benchmarks outperformed small company benchmarks, for growth and value styles.

- All nine S&P cap-weighted style boxes posted double digit total returns (large, mid, small / value, blend, growth), with large-cap growth posting the top return with a 27.44% total return, and small-cap value reaping the lowest total return at 11.51% for the year.

- Top performing U.S. sectors for the year were information technology, materials, and consumer discretionary, up 36.91% 21.39%, and 21.23% respectively.

- Worst performing U.S. sectors of the year were telecommunication services, energy, and real estate, posting returns of -5.97%, -3.80%, and 7.16% respectively.

- The U.S. Dollar Index posted its worst year since 2003, down 9.9% for the year. It was the only category (out of twelve) that posted a negative return.

- Crude oil prices rose while the S&P 500 Energy sector prices dropped on average, for the first time since 2002.

- MSCI Emerging Markets Index was the top performing index, with 30.55% total return in 2017. It outperformed the developed international MSCI EAFE index by 10.6% during the year.

- 42 of 44 countries posted positive returns in 2017, with Israel and Russia being the only countries to show negative price returns in their own currency.

- Gold rose by 13.80%. Commodities rebounded, with the S&P GSCI increasing in value by 11.1%.

- Fixed income had a surprisingly solid year, helped by international investors seeking secure, higher yielding investments. The Bloomberg Barclays U.S. Aggregate Bond Index posted a 3.54% return for the year.
Looking At 2018

We are optimistic that 2018 will be another strong year in the markets, with returns at or above historical norms. That said, we don’t expect it to be a repeat of 2017. Let’s address the challenging issues, and then we will finish with why we feel 2018 will be a successful year for investors.

Expect More Volatility: 2017 recorded one of the least volatile market years on record, with only a 2.9% correction during the year. This is the smallest correction in any given year since 1995.
What could influence the markets in 2018 to have greater volatility than what they experienced in 2017? A mid-term year election is a great place to begin looking. The markets don't like uncertainty. This upcoming election is certainly going to be interesting and entertaining, if nothing else. Second year of a presidential term is often the worst year as a result of this uncertainty, as the chart below indicates.

![Dow Industrials Four-Year Presidential Cycle](chart.png)
Market volatility could easily be churned up by the Federal Reserve continuing to increase Fed Fund rates. To the right is the probability where Fed Fund rates will be at the end of 2018.

This is a bit lower than where the Federal Reserve has projected they would like to have rates. As you can see from the chart to the right, the street doesn’t believe that the Federal Reserve will have the ability to raise rates as quickly as they would like.
Why is this important?
The bond market has an inverted relationship between price and yield. While we believe the bond market is at risk of losing value, the street is indicating that it doesn't believe that the Federal Reserve will be able to move as quickly as they would like.

Source: Barclays, Bloomberg, U.S. Treasury, Standard & Poor’s, FactSet
Another pressure to the markets is having a new Fed Chairman taking over during 2018. Jerome “Jay” Powell has been nominated to become the 16th chairman of the Federal Reserve Board. It seems like it will happen.

Here are a few facts about Jay Powell and Fed Chairs:

- For the record, I am not related to him in any way.
- A lawyer by education, Powell has spent most of his working life in the financial markets. Obama nominated him for a spot on the Fed Board of Governors, which he filled in 2012.
- Powell has worked closely and voted closely with current Chairwoman, Janet Yellen. We do not expect a radical change in the Fed’s position under new leadership.
- Historically, markets correct under a new Fed Chairman. We expect Powell’s appointment to have little or no impact on the market. This is due to the transparency the Fed now provides and Powell’s voting track record.

Because: The biggest reason that I feel the market will correct is because we haven’t had a correction is any substance for over 285 trading days. In other words, we are overdue. No market goes straight up (although this one has tried). This is highly unusual to not have more minor pull backs during a secular bull market. If we do experience a pullback in 2018, it will most likely be sentiment driven (meaning that the fundamentals of the bull cycle are still intact) and most likely will be shallow and short lived.

Now that we have looked at the things that could hold back the markets, let’s look at why we believe the markets will end 2018 higher than were they started.
Corporate Earnings

The S&P 500 broke all-time records for earnings in 2017. Expectations are for an even stronger 2018, as many large, international economies expand at greater rates than they expanded in 2017.

Source: FactSet, Compustat, and Standard & Poor's
Most of the economic data points are pointing toward a good economy in 2018.

We have very low unemployment and slow wage growth...


inflation under control...

Source: U.S. Bureau of Labor Statistics
yet the economy is expanding.

The Economy (The Index of Coincident Economic Indicators)

The Economy Gain/Annum When:

<table>
<thead>
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<th>Activity Index is:</th>
<th>Gain/ Annum</th>
<th>% of Time</th>
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<td>4.5</td>
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<td>2.5</td>
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</tr>
<tr>
<td>-0.59 and Below</td>
<td>-2.5</td>
<td>14.3</td>
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Monthly Data 5/31/1967 - 11/30/2017 (Log Scale)

Shaded areas represent National Bureau of Economic Research recessions.

Source: The Conference Board

Chicago Fed National Activity Index (Three-Month Smoothing)

Economy Growing Above Trend

11/30/2017 = 0.41

Source: Federal Reserve Bank of Chicago

A reading of zero indicates trend growth.

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Each year brings new challenges to our investment management team. As you already know, PGFG manages all of our strategies tactically, meaning we increase or decrease our exposure to the stock market based upon the risk we measure in the stock market. Each of our strategies has a baseline of how much exposure it will hold in equities on average. We increase that exposure if we feel risk has dropped. Conversely, we lower our equity exposure when our research indicates that risk is increasing.

We feel that it will be extremely important to be nimble in 2018. We foresee this market requiring us to shift allocations several times to stay in front of the stronger sectors of the market, as leadership changes during the year. We also feel that 2018 will be a difficult year for bond investors, especially in the long and intermediate durations. I am very confident that our team of investment professionals can successfully navigate these challenging and uncharted waters.

As always, I welcome your questions and comments, and I encourage you to meet with your Polaris Greystone wealth advisor to keep up to date with our service offering.

Sincerely,

Jeffrey J. Powell
Managing Partner, Chief Investment Officer