



OUR VIEW



Economic growth exceeded expectations, with the U.S., Japan and Europe all delivering above-trend economic growth. Corporate profits followed the path of economic growth.

2017 Review and 2018 Market Outlook

2017 Market Performance

TFC started 2017 expecting moderate worldwide economic growth, but were concerned about the potential for trade protectionism in the U.S., populist movements in Europe and tensions with China and North Korea. Economic growth exceeded expectations, with the U.S., Japan and Europe all delivering above-trend economic growth. Corporate profits followed the path of economic growth. The market's worst geopolitical fears were largely avoided, as worst-case outcomes for European elections, trade policy and Chinese growth were avoided. President Trump's first year in office was heavy with tweets but light on the type of negative economic policy actions feared by the market.

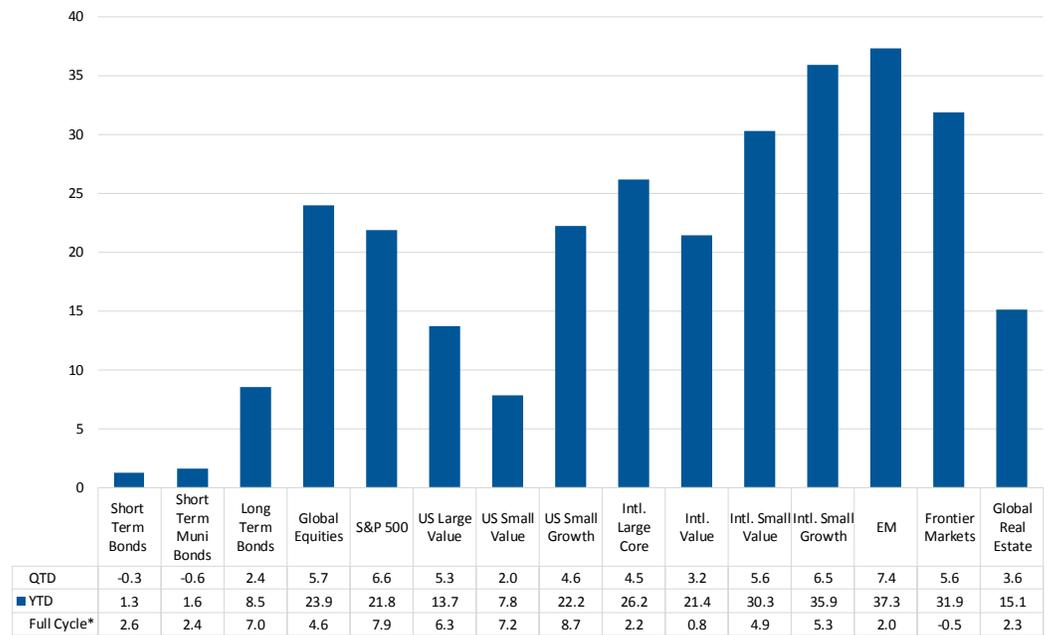
Global equities, as represented by the MSCI All Country World Index, gained 24% for the year. U.S. equities continued to reach record highs, with the S&P 500 Index gaining more than 21%. Emerging market equities gained more than 37%, boosted by outstanding performance from Chinese technology stocks. The year in equity markets was remarkable for the lack of market volatility. The largest peak to trough drawdown in the U.S. equity market in 2017 was 3%, the smallest decline since 1995.

Value stocks trailed growth stocks in 2017, reversing last year's value outperformance. The U.S. technology sector gained more than 38%, a reflection of rapid earnings growth and "winner take all" business dynamics in many technology segments. The energy and telecommunications sectors lagged with negative returns for 2017, though rising oil prices helped energy stocks in the latter part of the year.

The bond market was largely a "coupon clipping" exercise offering low, but positive returns for the year. The long dated treasuries did quite well as rates fell slightly. 10-year Treasuries were virtually unchanged for the year, though yields on shorter-term government bonds moved up as the Federal Reserve raised short term interest rates. While yields did rise on the short end of the curve, the income offset the modest price decline. Cash yields on money funds also increased and are now delivering at least a modest return. U.S. high yield and emerging markets bonds were strong performers as credit spreads in general tightened in a year in which risk was rewarded.



2017 Asset Class Returns



*Beginning date: 10/2007

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TFC client portfolios benefited during the year from strong global equity markets and allocation to international equities. TFC’s emerging markets and international small company holdings were particular standouts. U.S. value stocks were out of favor, and were a drag on performance. We believe that trends reverse with little advance notice and are confident that value will revert to form over the long-term. U.S. real estate holdings struggled to provide positive returns, but non-U.S. real estate picked up some of the slack. TFC’s holdings in mostly high-quality, shorter-duration fixed income investments provided positive albeit unexciting returns.

Economic and Market Outlook

The December passage of a nearly 1,100 page tax bill provided President Trump with the first significant legislative victory of his Presidency. What some skeptics label as a “made for Twitter” tax bill is likely to offer a near-term economic boost, helping the GOP heading into midterm elections. In the words of one economist, the bill is more “carbs than protein,” and will not create meaningfully higher long-term growth for an economy constrained by demographics, deficits and debt. The changes in business taxation will have the most significant economic impact, as the U.S. will move from having one of the highest corporate tax burdens in the world to being in the middle of the pack. Corporate profits should get a boost in 2018, particularly small company stocks, many of which pay close to the statutory maximum tax rate. Given the complexity of the tax bill, we expect a challenging year in which investors and tax advisors spend considerable time interpreting the implications of the vast array of changes. (For more on the tax bill, please read our financial planning newsletter sent in late December and Dan’s recent article in [U.S. News & World Report.](#))

The U.S. economic recovery is in late cycle, but the outlook is for strong corporate earnings growth to continue in 2018. Economic growth in much of the rest of the world is still accelerating.



European growth is supported by declining unemployment, increased business investment and stronger global trade. Japan is benefiting from the synchronized global economic recovery and from incremental improvement in corporate governance and domestic consumption. Chinese growth is slowing, but so far remains strong enough to minimize spillover effects to other countries.

The risks we were concerned with entering 2017 haven't disappeared. Italian elections are looming, with populist candidates attracting a significant share of voter support. In the United Kingdom, widespread discontent may doom Theresa May's fragile government and disrupt Brexit negotiations. Tensions with North Korea are escalating, and unrest in the Middle East has returned to the spotlight with protests in Iran and moves by Saudi Arabia's new ruler against potential opponents.

In our view, however, the primary risks for 2018 involve Federal Reserve policy, Chinese growth and trade protectionism. Although asset bubbles are most feared by many investors, it's more likely that the next recession will be triggered by Fed policy responses to an overheating economy or a pickup in inflation. Wage inflation has stayed in check despite dramatic reductions in unemployment since the Global Financial Crisis. However, average wage growth may mask wage pressures that are building under the surface. Stagnant wages in retailing and financial services and changes in the workforce as highly paid baby boomers retire are factors that lower the average wage growth. Less visible are wage pressures that appear to be building in industries such as construction and technology, in which employers are competing in a tight pool for talent. We think that wage inflation is likely to "grind" higher rather than move too sharply, giving central banks the latitude to raise rates in a gradual manner. If wage inflation picks up more rapidly, the Fed may need to move more aggressively to raise rates, which could accelerate the timing of the next recession. In addition, oil prices have been trending up, in part a reflection of increased volatility in the Middle East. We think that U.S. shale oil supply will contain the upside for oil prices, but an unanticipated spike in oil prices could be another potential catalyst for the Fed to move more aggressively than we expect. An environment in which inflation is at stubbornly low levels has helped to support high equity market valuations and a constructive market for "risky" assets. A significant change in inflation expectations could be a catalyst for valuation multiples to revert to less attractive levels, i.e., trigger a stock market correction or worse.

Chinese growth is a second risk factor. China is prioritizing financial sector deleveraging, a crackdown on corruption, and ongoing (and somewhat unappreciated) restructuring of the industrial sector. Skeptics view the anti-corruption moves as a way to sideline political rivals to President Xi Jinping, though public sentiment favors an end to the widespread corruption that became pervasive during China's rapid economic expansion. The Chinese Communist Party isn't blind to the frequent fate of authoritarian states after growth stalls. The party also appears to recognize that the middle class has rising expectations, and that the rise of income inequality is creating societal unrest. China is gradually reducing leverage at financial institutions and state-owned enterprises, while slowing the pace of real estate speculation. The risk to the global economy is that China fails to effectively manage the tension between growth and reform. Overly aggressive reforms might satisfy the more austere economists around the world, but potentially at the cost of a severe slowdown in growth within China. With China representing nearly 30% of global growth, a Chinese "hard landing" would create growth challenges elsewhere in the world. If

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China is too cautious in economic reforms, the risk of economic overheating increases and China's long-term economic challenges will become more difficult to resolve. Consensus expectations are for a "soft" landing in China, but we will be monitoring leading indicators to identify signs of a policy-induced slowdown or acceleration.

A third risk is that protectionist trade moves, much discussed in Twitter threats to abandon NAFTA and impose sanctions on China, become a material part of the 2018 agenda for President Trump. We are well aware of the shortcomings in current trade agreements, including weak intellectual property protections, but an exit of NAFTA or a tariff war with China is likely to harm economic growth and create a surge in inflation.

Closing Thoughts

The durability of the tax bill may be a relevant issue, though not an immediate issue in 2018. The bill passed without any Democratic votes; there will be big winners and big losers resulting from the complex bill, and the potential for unintended consequences is quite high. The combination of these three factors makes a renewed battle over taxes likely whenever the Democratic Party returns to power.

The synchronized global expansion, low inflation and reasonably easy financial conditions support a low volatility environment. However, volatility may return with minimal notice. We are not convinced that problems with market structure have been resolved or that "crowded trades" driven by algorithms won't create issues when the consensus view changes. We think the "new normal" may be extended periods of low volatility when a dominant economic trend is in place, followed by spikes in volatility when the trend is disrupted.

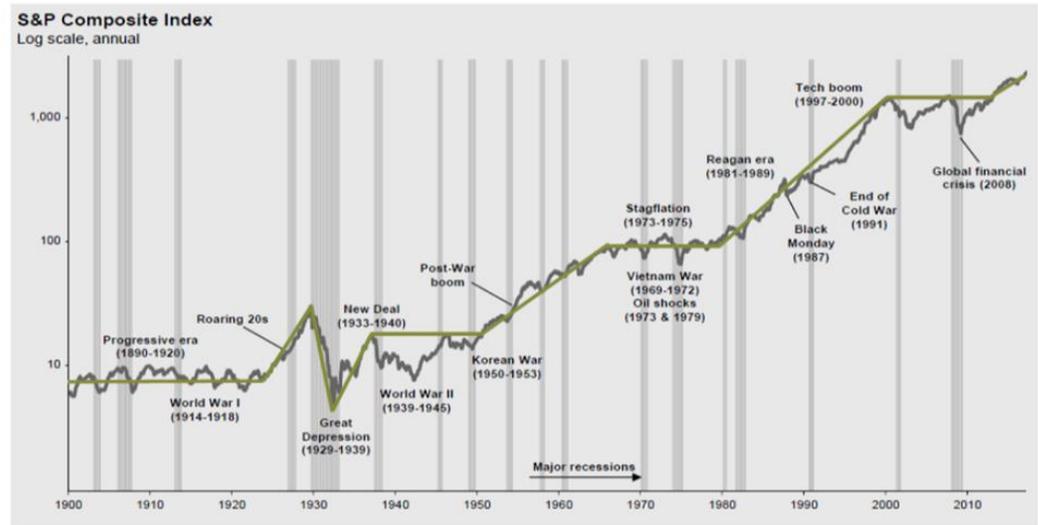
Overall, the continuation of a "Goldilocks" economy – "not too hot, not too cold" -- supports a bull market for equities that could extend well into 2018. It is important to remember that the final stage of a bull market is typically highly rewarding. However, given the long bull market and elevated valuations in the U.S., the risk of a recession is a possibility that shouldn't be ignored. We have a negative near-term outlook for bond returns, given the likelihood that interest rates will move up in 2018, and expect another low yielding, "coupon clipping" year. However, bonds provide liquidity and relative stability, and necessary hedge against equity risks given the potential for a recession and bear market during the next 3-5 years. Overzealous policy tightening still represents the greatest threat to a pro-risk stance, but with economic data positive and inflation subdued, the Federal Reserve may have the luxury of taking a slow and steady path. As the last few years have shown, moderate growth, dovish central bank policies and low inflation have been an ideal backdrop for stock market investors.

While the current business cycle in the US is already the third longest in duration, all good things must come to an end in order to begin again. A bear market which usually accompany recessions is likely when we think beyond the near-term time horizon.

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Bear markets rarely occur unless there is a recession.



Source: FactSet, NBER, Robert Shiller, JP Morgan Asset Management

We continue to be aware of the potential for an economic downturn, policy mistakes, or geopolitical conflict that spills over into the markets. To that end, we are continuing to rebalance portfolios for most clients to asset allocation policy targets (generally reducing equities and increasing fixed income) and are also reserving cash for anticipated withdrawals.

We monitor the risks outlined above and will incrementally adjust the portfolio based on new information.

2017 Tax Year Information

The 1099 tax preparation forms will be sent (or available online) to you mid to late February by your account custodian (Charles Schwab, Fidelity or National Advisors Trust). This report will include income and realized gain/loss information and summary of fees and expenses. Please be aware that these reports may be revised and corrected by the reporting custodian through March 2018. In addition, you may also view our summary of investment management fees through your client portal access.

As always, we welcome your comments and questions.

Sincerely,

Daniel S. Kern, CFA, CFP®
Chief Investment Officer

Renée Kwok, CFP®
President and CEO

James L. Joslin, CFP®
Chairman



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For joint marketing with other financial companies	No	We do not share
For our affiliates' everyday business purposes— information about your transactions and experiences	No	We do not share
For our affiliates' everyday business purposes— information about your creditworthiness	No	We do not share
For nonaffiliates to market to you	No	We do not share

Questions?	Call 617-210-6700 or go to www.tfcfinancial.com
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TFC Financial Management, Inc.

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How does

TFC Financial Management, Inc. collect my personal information?

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- Open an account or Give us your employment history
- Pay your bills or Give us your wage statements
- Make deposits or withdrawals from your account

TFC Financial Management, Inc. also collects your personal information from other companies.

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- sharing for affiliates' everyday business purposes—information about your creditworthiness
- affiliates from using your information to market to you
- sharing for nonaffiliates to market to you

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