JOHN D. DOVICH & ASSOCIATES, LLC

Market Update — Fourth Quarter 2017

2017: A Year in Review

Index	Total Return 4Q17	Total Return YTD
S&P 500 (large cap US stocks)	6.6%	21.8%
Russell Mid Cap	6.1%	18.5%
Russell 2000 (small cap US stocks)	3.3%	14.7%
MSCI EAFE (large cap foreign)	4.2%	25.0%
MSCI Emerging Markets	7.4%	37.3%
MSCI ACWI All Cap (global stocks)	5.7%	24.0%
Barclays US Aggregate Bond	0.4%	3.5%

A year ago, Republicans basked in the glory of sweeping the November elections, fueling fresh optimism in the stock market. Investors anticipated lower corporate and personal taxes, regulation overhaul and other fiscal policies designed to foster economic growth. Despite US political volatility, the economy continues to gain momentum. The recent corporate tax reform provided an additional boost to the stock market as the year closed.

The "goldilocks" economy contributed to strong returns in the US markets with the S&P 500 leading the way with a 21.8% gain. International stocks performed even better, with the MSCI EAFE Index up 25.0%, after several years underperforming US stocks. US bonds posted a solid return of 3.5% for the year. Despite many negative events that could have derailed the stock market in 2017, investors remained optimistic about an improving economy and tax reform. In the past year, global political turmoil, concerns over North Korea, three hurricanes striking the U.S. in rapid succession and the Fed tightening interest rates and reducing its balance sheet did little to curb enthusiasm for the stock market.

The stock bull market, represented by the S&P 500, reached a duration of 105 months, providing a 295% price return since March 2009. During 2017, synchronized global growth, strong corporate profits, benign inflation and low interest rates contributed to the strongest returns in the stock market since 2013, when the S&P 500 returned over 32%. Historically, the average bull market is 92 months in duration and averages a gain of 259%. The current bull market provided the fourth best historical return through December 2017. The bull market that began in January 1988 and ended in August 2000 lasted 152 months and gained 514% in price. While impressive, the current bull market could still have legs.

The Federal Reserve

As we discussed in the Q3-2017 market commentary, we believe one of the greatest risks to the financial markets, besides geopolitical risk, is how the Fed handles normalizing monetary policy. As expected, the Fed increased interest rates by 25 basis points in December, the fourth 25 basis point increase in rates since December 2015.

In November 2017, President Trump nominated Jerome Powell as the new Fed chair, to replace Janet Yellen, whose 4-year term expires February 3, 2018. Mr. Powell supported many of Ms. Yellen's monetary policy decisions during her tenure. It is expected he will continue to slowly raise rates while reducing the Fed's balance sheet. One difference is Jerome Powell is an attorney, not an economist. He is the first non-economist to hold this position in nearly 40 years. However, Mr. Powell's experience in investment banking and private equity provides broad experience in a changing financial landscape that should serve him well.

The concern regarding the Federal Reserve is they may move too quickly to raise interest rates if economic growth accelerates faster than expected. Unfortunately, in previous economic expansions, Federal Reserve rate hikes contributed to recessions. However, with the expected appointment of Jerome Powell, these risks appear to be diminished due to his similar views as Fed Chair Yellen.

Economy

While final fourth quarter manufacturing numbers are not yet available, global economic growth remained strong through November. Exceptions to synchronized global growth are China and the UK. During 2017, Chinese growth decelerated and is expected to decelerate throughout 2018. China's newly elected Communist party is expected to rein in debt by abandoning its long-term economic targets. This may put pressure on their gross domestic product (GDP). UK economic activity is slowing amid concerns about Brexit. US economic activity continues to gradually accelerate. Recent corporate tax cuts are expected to bolster economic growth. Overall, global economic growth remains strong and a recession in 2018 appears to be a low risk.

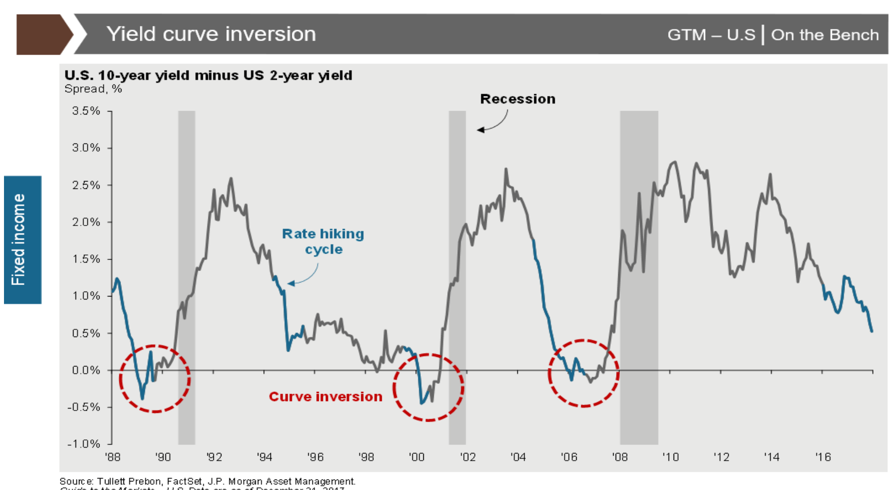
Interest rates and inverted yield curves

The length of the economic cycle and Fed policy are important in our assessment regarding the sustainability of the economic expansion and stock bull market. Now two years into the Federal Reserve interest rate hike cycle, we believe it's a good time to assess how their actions have impacted interest rates and the Treasury yield curve.

While rising interest rates are worrisome to some in the investment community, gradual interest rate increases do not concern us as much. As the economy shows growth in the form of improving GDP numbers, growth can lead to inflationary pressures. A low level of inflation is healthy for a growing economy. The Fed has targeted 2% for personal consumption expenditures (PCE) when tracking inflation in the US economy. Inflation that moves beyond this 2% level on a sustainable basis may lead to a more aggressive rate hike policy. As a reminder, the Fed's mandate is to maximize sustainable employment and to support stable prices with moderate long-term interest rates.

This brings us to a discussion about the Treasury yield curve. The national media is beginning to focus more attention around the flattening yield curve. In a normal economy with 2% GDP growth, the 10-yr. Treasury yield is typically higher than the 2-yr. Treasury yield. In faster growing economies, the Fed raises short-term interest rates to slow economic activity to a normal level. One measure to evaluate the flattening yield curve is the relationship between the 2-yr. and 10-yr. Treasury yields.

As you will see in the chart below, there is usually a point when 2-yr. Treasury yields exceed 10-yr. Treasury yields. In this example, when the spread between the 10-yr. yield and 2-yr. yield falls below zero percent, the yield curve has inverted, meaning short-term rates are higher than longer term rates. This chart shows that each recession over the past thirty years, denoted in gray, has been preceded by a yield curve inversion. This chart also shows that there is a time lag between a yield curve inversion and a recession. The reality is the S&P 500 has historically performed the best when this yield spread is between 0-50. We are currently at a 52-basis point spread. This chart seems to reinforce that a recession is not imminent and that the stock market may continue to perform well, if economic growth and inflation remain steady. However, this is a chart we monitor closely to help us assess future economic conditions and how this may impact your investments.



Source: Tullett Prebon, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2017.

2018 Market Outlook

With synchronized global economic growth, benign inflation and low global interest rates, the outlook for global stocks in 2018 remains positive. 2017 provided one of the lowest periods of stock market volatility on record. While volatility is likely to increase, we are cautiously optimistic about the stock market in 2018. After another solid year of bond returns in 2017, we expect to see moderate bond returns in the future. A primary catalyst for above average bond returns is declining interest rates. In the US, rates are rising. In the rest of the world, this is a mixed picture. While we are less sanguine about the bond market than the stock market, bonds remain an important part of a diversified portfolio to provide risk management with your investments.

Conclusion

The stock market posted a strong quarter and full year. With this in mind, it is important to remind you that a 5-10% selloff in the stock market has been a normal occurrence in previous years. This did not occur in 2017. Therefore, reviewing your asset allocation and risk tolerance with your advisor this year is a sound practice in remaining focused on your long-term goals.

All of us at John D. Dovich & Associates, LLC thank you for the opportunity to serve you and your family. We look forward to discussing any financial issues you may have and send along warm wishes for a happy new year!

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Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

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Index and sector performance information in the Market Commentary sourced from Morningstar.

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