MARKET REVIEW & OUTLOOK

FOR MORE INFORMATION PLEASE VISIT WWW.SFGINC.COM OR CALL (775) 850-5620.

Looking back on 2017 and ahead to 2018

REFLECTING ON THE WORLD IN 2017

Global economies and financial markets continued to gather steam in 2017 amid strong corporate profits, record low volatility, and benign inflation expectations. Here's a breakdown of what the world looked like last year:

U.S.

The year started with positive momentum in anticipation of fewer regulations, lower taxes, and higher infrastructure spending under the new administration. As lower tax rates became a reality at both the individual and corporate levels,

SFG
A Legacy of Trust and Innovation

equity valuations were stretched further and the market extended its bull cycle for another year. The U.S. economy also gained strength as unemployment hit 17-year lows and GDP marched closer to the 3% target.

ASIA

Economic growth continued across the region, with Japan benefiting from strong exports and increased business investment while China maintained its momentum despite unprecedented credit growth. However, emerging markets stole the spotlight as the year's best-performing asset class.[1] For our perspective on emerging markets, please read our blog post — shifting the perception of emerging asia.

EUROPE

The European Central Bank maintained its easy monetary policy and asset purchase program, fueling the equity markets. Indicators across the region continued showing improvement to provide a boost to investor confidence.

While mainland Europe experienced growth, the U.K. economic and business investment landscape remained sluggish due to uncertainties surrounding the shape and timing of Brexit. Both auto sales and the housing market faltered as real wage growth in the U.K. was negative for the year.

VOLATILITY AND COMPLACENCY

Commonly referred to as "Wall Street's Fear Gauge," the VIX is a measure of the market's expectation for 30-day volatility. As the VIX hovered around record lows for most of 2017, a combination of low interest rates and easy monetary policy increased investors' appetite for risk.

Complacency spread throughout global markets, most notably in European fixed income. For the first time in history, high yield European bonds yielded less than 10-year U.S. Treasuries.

U.S. POLICY CHANGES AND IMPLICATIONS

The "Tax Cuts and Jobs Act" signed into law last December permanently cut corporate tax rates to 21% and temporarily reduced individual tax rates. It also eliminated the individual mandate requiring everyone to carry health insurance. You can learn more about the new tax law in our blog post — tax cuts and jobs act, an overview.

The federal deficit is expected to add about $1.5 trillion to the debt over the coming decade as a result of the new tax act. Supporters of the policy contend it will make America more competitive globally and spur economic growth, leading to higher company revenues and government tax collections. Critics believe the rest of the world will be quick to reduce their corporate tax rates in order to maintain a competitive advantage.

Short-term implications are positive, as companies are expected to fuel growth and pay down debt. However, long-term implications remain unclear, depending on whether companies return their profits to investors via dividends, share buybacks to boost stock prices, or to make capital investments such as new factories and technologies.

GEOPOLITICS

North Korea made headlines throughout the year by testing their nuclear capabilities and escalating tensions with both Japan and South Korea. The impact on markets has been minimal, and animosities are currently on hold as both North and South Korea participate together in the 2018 Winter Olympics.

Tensions in the Middle East ramped up after President Trump decided to recognize Jerusalem as the capital of Israel and move the U.S. embassy there from Tel Aviv. Toward the end of the year, tensions rose again as Iran and Saudi Arabia began to jostle over power in the region.

---

[1] Source : J.P. Morgan Asset Management *Guide to the Markets* 1Q18.

GOING FORWARD IN 2018

Enjoy the sunshine, but bring an umbrella. As we enter 2018, it's more important than ever to be aware of the risk factors when investing. In early February, we saw how sudden and stinging a near 10% correction to the equity markets can be. That downturn may be just a sampling of what's in store for the future as markets feel the effects of debt, illiquidity, rising interest rates, and geopolitical tensions.

DEBT

The amount of global debt raises a red flag entering the New Year. Following the 2008 Financial Crisis, a combination of lower interest rates and quantitative easing programs pushed the national debt above $20 trillion.[2] Recent policy changes, such as the new tax act, are expected to add another $1.5 trillion to the debt over the next 10 years (it is estimated that $1 trillion of that will come from this year alone).

Both state and local deficit and debt levels in general remain high in the wake of the last recession. This situation may continue to worsen as both healthcare and pension costs weigh on governments. For more information about unfunded pension liabilities, please read our blog post.

China is another large issuer of debt. The news has focused mainly on China's ability to sustain high levels of GDP growth; however, that growth has been fueled by credit. Chinese officials report that their total debt is hovering around 260% of GDP.[3] These figures may actually be even higher and pose an even greater concern, as China has been known to manipulate its domestic data.[4]

While leverage was the cause of the Financial Crisis in 2008, we believe the next major correction will be due to the amount of debt in the system globally. As part of our Risk Management process, we utilize scenario planning to: 1) shape our perspective and 2) create a plan that better identifies major and black swan events and minimizes the impact on our clients' portfolios. Our goal is to react, not predict.

LACK OF LIQUIDITY

Liquidity is one of the most important factors to consider when investing. In terms of liquidity, the financial markets are facing a turning point as the Federal Reserve has begun monetary tightening policies. As other central banks start to shrink their balance sheets, the result could be reduced liquidity and increased market volatility.

Regulations such as the Volcker rule, which was put in place as a response to the 2008 Financial Crisis, may also create a liquidity squeeze in the market. Because of this rule, investment banks were required to shut down trading desks that had provided liquidity to the system. A lack of market makers in the investment banks' absence could trigger significant losses during major sell-offs.

As we note in our Active vs. Passive white paper, passive investment vehicles are highly sensitive to price movements. During periods of major selling, they are required to sell off large bundles of assets in short periods of time, leading to larger spreads between the bid and ask prices.

[2] Source: https://www.cnbc.com/2017/11/29/yellen-20-trillion-national-debt-should-keep-people-awake-at-night.html

[3] Source: https://www.forbes.com/sites/douglasbulloch/2017/12/15/chinas-debt-bomb-just-keeps-getting-bigger/#5f75f9e3be4f

[4] Source : http://www.telegraph.co.uk/finance/economics/11930766/The-truth-behind-Chinas-manipulated-economic-numbers.html

RISING INTEREST RATES

Citing a prolonged nine-year economic recovery, the Fed has continued on a change of direction in monetary policy. If the Fed continues to raise rates, it will have a ripple effect across borrowers. Example: The total amount of student loan debt is marching higher every year, much of it with variable interest rates. As the Fed raises the cost of borrowing, millions may see their monthly student loan payments increase.

As companies look to refinance their debt, they will be subject to higher borrowing costs and debt service payments in this new environment, which could trigger an economic slowdown. This is an issue we will monitor closely as the Fed is projected to raise rates three or four times throughout 2018. It's crucial to manage duration during periods of rising interest rates. The longer a bond's maturity, the more sensitive it is to rate movements. By mitigating this sensitivity in times of increasing rates, we can help better insulate client portfolios from downside risk.

GEOPOLITICAL TENSIONS

North Korea is a question mark going forward. The 2018 Winter Olympics has done much to calm the tensions between countries. The hope is that this momentum will carry through after the games and a treaty can be reached.

Much like the last decade, tension remains the norm in the Middle East. The region has been plagued with corruption and military uprisings that will continue to impact oil prices and production in 2018.

We remain vigilant in monitoring both of these major geopolitical hotspots. Because we don't forecast, we won't predict what they have in store for us. Rest assured that we have these scenarios, and we are prepared to react in the event things take a turn for the worse.

CONCLUSION

Investing in this current market cycle is challenging because fundamentals do not necessarily apply. "Fear of Missing Out" ("FOMO") now prevails and often causes investors to make imprudent decisions. We don't know when the current cycle will end, so we'll continue using scenario planning to stress test portfolios and manage risk. (Read more about Scenario Planning versus Forecasting on our blog.) Because we believe markets trade on fundamentals over the long term, we remain focused on Risk Management and portfolio diversification in addition to investment strategy and manager selection.

Visit us at sfginc.com to read more about relevant, timely blogs or give us a call to discuss your situation at (775) 850-5620.

SCHULTZ FINANCIAL GROUP INC.
10765 Double R Blvd., Suite 200 • Reno NV 89521

SFG™
A Legacy of Trust and Innovation