Investment Insight

2017
Fourth Quarter
Legacy Wealth Management®

THE YEAR IN REVIEW

Markets often produce unexpected results. While our expectations for 2017 were certainly positive, markets around the world have exceeded our expectations and produced some pleasant surprises this year. The U.S. stock markets are up 14% to just over 21%, with small companies (represented by the Russell 2000 stock index) on the lower end of that scale and the largest companies (represented by the S&P 500 stock index) leading the way for the year (this order was just the opposite in 2016). International developed markets (MSCI All-Country World ex-US index) have seen gains of 27%, while emerging market stocks (MSCI Emerging Markets index) have gained as much as 37% (driven largely by China). Fixed income securities (bonds) have also had a good year in spite of rising rates (remember, rising rates typically mean falling prices for bonds). Returns in our high-quality bonds (approximately 80% of bond allocation for most clients) have been approximately 3%. While these returns are not exciting compared with those of the equity markets cited above, keep in mind that the fixed income portion of your allocation is your anchor in the storm, steadying the portfolio when equity market volatility appears (and it will again). For most clients, a smaller portion of the fixed income allocation is invested in the high-yield and emerging market bond markets and has seen returns for this year from 7% (high-yield) to 11% (emerging markets). All returns cited here are before fees and assume a static investment amount for the full year; your returns could be different if you had deposits/withdrawals.

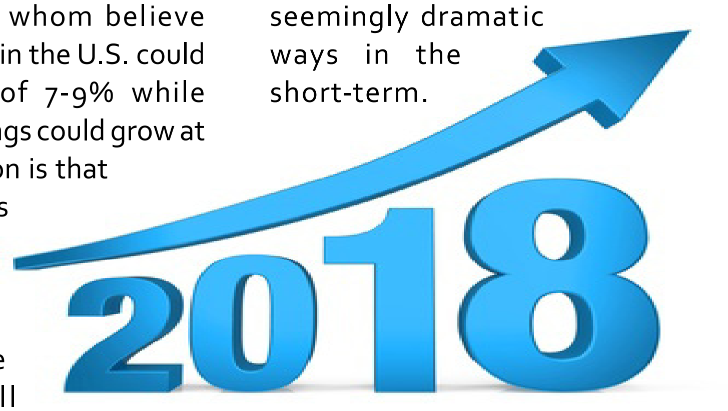
Investors could understandably have one of two reactions to the higher-than-expected returns of 2017 – 1) should I take more risk to get more returns like this? or 2) there’s no way this can continue, so should I significantly reduce my risk to protect my money? Our response is that you should likely stay the course and continue to invest in a balanced way that helps achieve your planning goals. Let’s review some of the reasons why equity markets have been climbing, why we believe they can continue to rise (albeit not at the same pace as 2017), and what we see as the risks to rising markets.

HOW WE GOT TO WHERE WE ARE

Equity markets over the past eight years or so have been rising off of the very low levels the market reached in the 2008-2009 crisis. Companies cut costs any way they could, consumers had very low confidence in the markets and were also reducing spending, and the government (specifically the Federal Reserve) was doing all it could to reduce interest rates and push the resulting "cheap money" (liquidity) into the banking system so that banks would survive and support both businesses and consumers with loans. Ten years of low interest rates has meant that businesses and consumers could adjust to new circumstances and, over time, regain their confidence. As companies have returned to profitability and growth, their stock prices have risen and have far outpaced returns offered by fixed income, leading investors to invest more in stocks relative to bonds, which in turn pushed stock prices even higher as investors sought higher returns. This has been not only a recovery from market lows, but a liquidity-fueled rise in stock prices and other assets like housing as well.

WHAT COMES NEXT?

U.S. stock market indexes like the S&P 500 have hit record highs this year. Many investors fear that this simply can't continue, but we think it is reasonable to expect rising markets to continue into 2018. While the Federal Reserve is raising interest rates, it is doing so at a measured pace based on their confidence in a continued recovery. So while interest rates are going up, it is and will continue to be relatively easy and inexpensive to borrow. Unemployment is very low and is likely to continue lower. Expanding businesses with a tight labor market should mean that wages increase (those gains have been modest so far, but should continue). All of this is supported by at least some near-term benefit to businesses and consumers from the tax reform that is taking place. *(See chart on back cover for updated personal tax brackets. For more information on the recent tax reform, contact your Relationship Manager or your CPA.)* We have heard or read support for these views recently from JP Morgan, Barrons, and ITR Economics, all of whom believe corporate earnings in the U.S. could grow at a pace of 7-9% while international earnings could grow at 12%. Our conclusion is that equity markets could continue to rise into 2018, albeit at a slower pace, and that the bond markets will continue to provide the slow and steady protection that we want in a well-diversified portfolio.



RISKS TO THE OUTLOOK FOR CONTINUED GROWTH

Of course there are always risks to a rising market. Geopolitical risks are ever present, but seem heightened currently with the tensions around North Korea's nuclear capabilities. Kim Jung Un is certainly worrisome, but he has the preservation of his power as his central goal. As a result, the posturing by both North Korea and the U.S. is likely to continue, but we hope will remain just that – posturing.

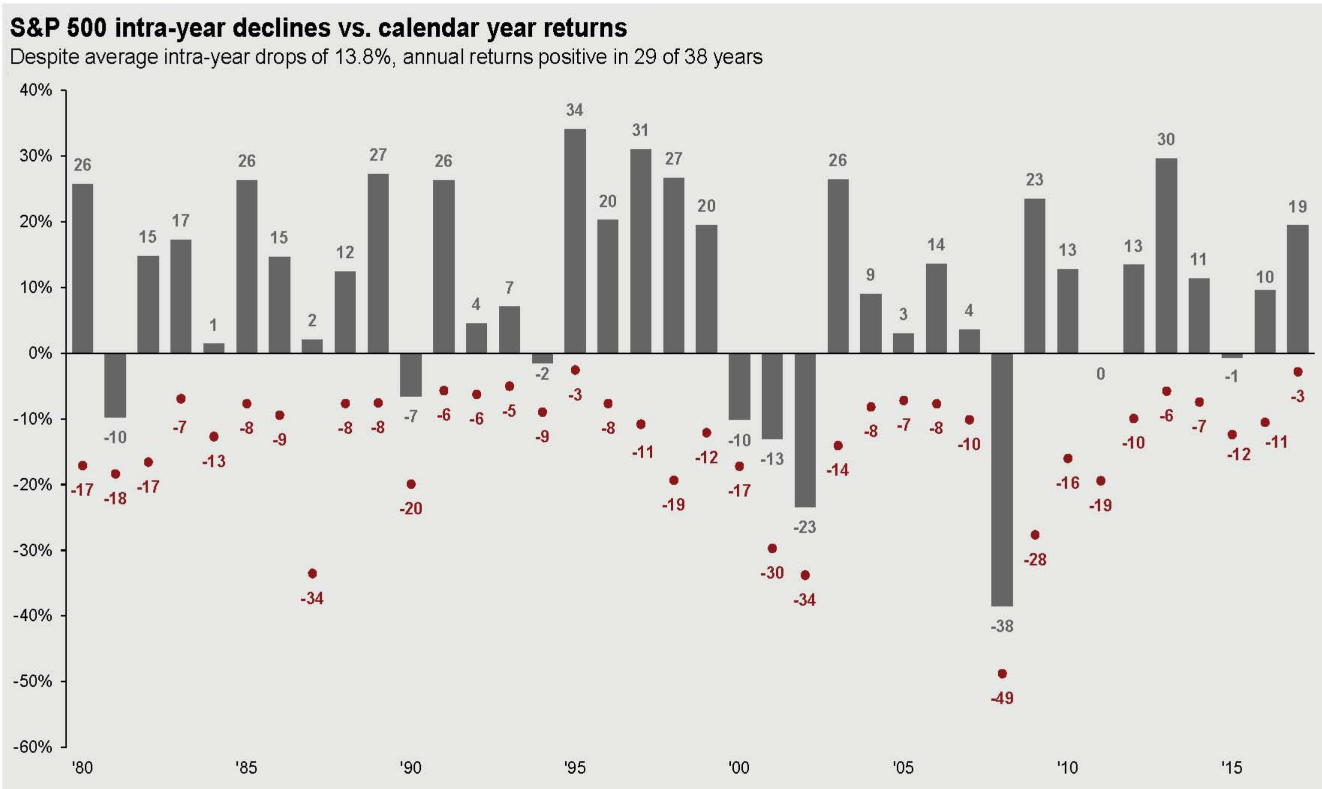
2018 will also see congressional elections here in the U.S. The Republicans hold a very thin majority in the Senate and a slightly larger edge in the House, but those numbers are changing with new scandals that come to light. The elections in November should be interesting and could see a change in control of at least one house of Congress, but it is too early to tell at this point what implications, if any, that might hold for the markets.

Finally, we all need to remember that markets can fall in seemingly dramatic ways in the short-term.

JP Morgan publishes a chart (*right*) that shows intra-year declines in the market as measured by the S&P 500 stock index. In the last thirty seven years, the markets have experienced a decline of ten percent or more twenty five times! Just in the recovery from the bottom of the market in March 2009, we have seen market declines of 16%, 19%, 10%, 12%, and 11% (2010, 2011, 2012, 2015, and 2016 respectively). These drawdowns are never fun, but they are generally short-term in nature, so it is important to hold the course with a balanced portfolio so that you don't miss the upside that has always followed such downturns.

Annual returns and intra-year declines

Equities



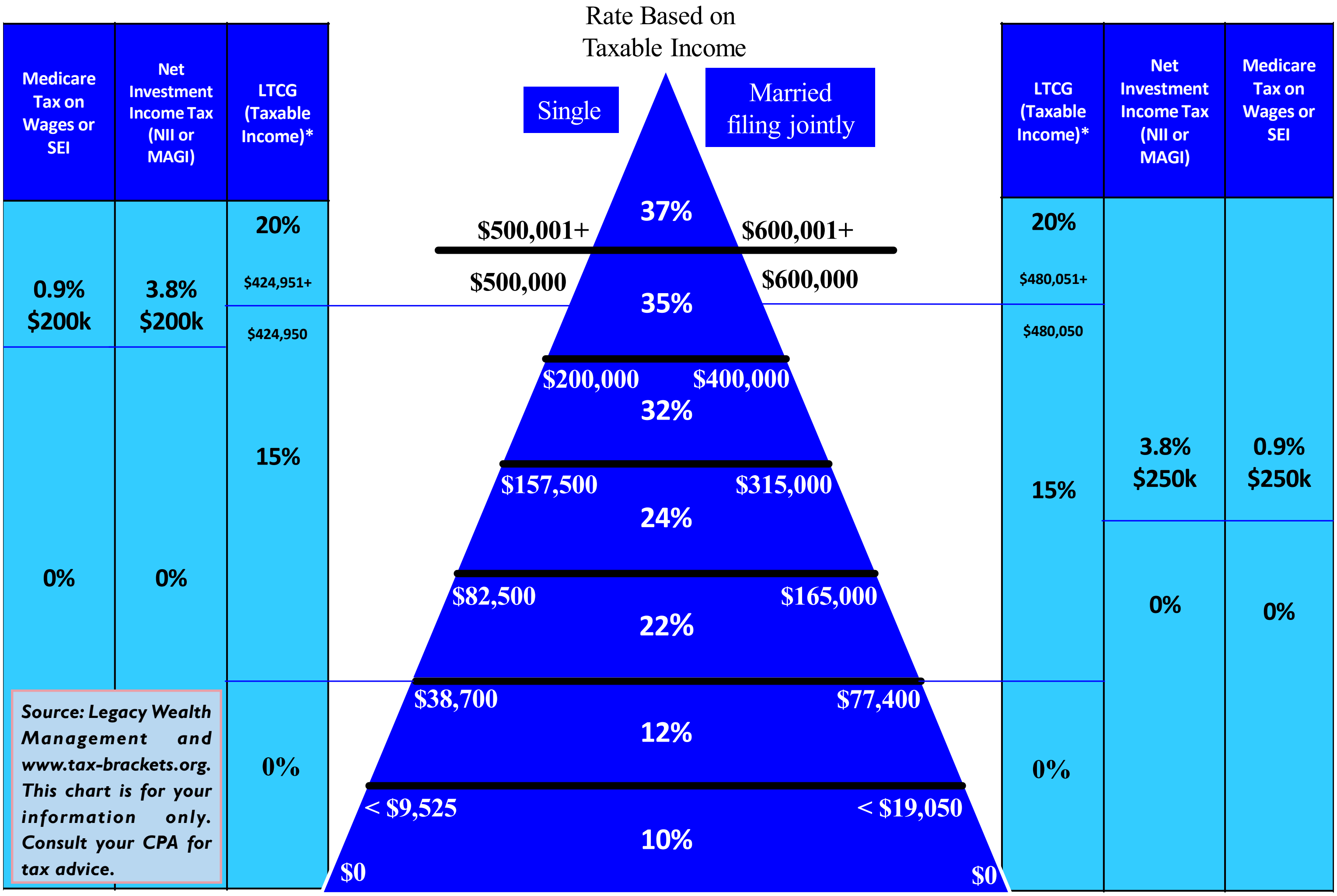
Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%.
Guide to the Markets – U.S. Data are as of December 31, 2017.

As we enter the New Year, we would encourage you to work with your relationship manager at Legacy Wealth Management to review your existing financial plan or to put one in place if you haven't done so already. Knowing that you have a plan in place that takes into account both the ups and downs of the markets can greatly improve your opportunities to accomplish what matters most to you and your family.

This Fourth Quarter Investment Insight *has been written by Legacy's Managing Director of Client Service Duncan Miller.*

The views of this commentary are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Investors should not use this information as the sole basis for investment decisions. Past performance is no guarantee of future results. Any statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed.

2018 Federal Income Tax Rates and Brackets



* Capital gains are taxed at either 0%, 15%, or 20%, depending on AGI.