1st Quarter Outlook 2018

I|S|G
INVESTMENT SECURITY GROUP, INC.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"Empty pockets never held anyone back. Only empty heads and empty hearts can do that".

--Norman Vincent Peale

Key Takeaways:

- **The current goldilocks environment of synchronized global growth and low but gently rising inflation looks to persist ......but the extent and pace of central bank tightening may determine whether markets return to "normal", higher levels of volatility which in our view equates to more frequent bouts of 5% or 10% short-term market setbacks.**
- **Greater-than-expected tax cuts and increased federal spending look to add momentum to a U.S. economy that seems to be breaking out of its slow growth doldrums following the Great Recession. Some of this good news however, may already be baked into stock prices which means U.S. stocks may face some tougher sledding in the year ahead.**
- **A broad-based earnings revival across the European region along with modestly cheaper stock valuations (vs. the U.S.) and a less restrictive central bank should pave the way for continued advances in European stock markets. Asian stock prices, too, should continue to benefit from improving growth prospects in Japan and China's burgeoning consumer appetite.**
- **For most investors, it remains prudent to diversify and manage stock risk exposures as global stock markets prepare for a less accommodative monetary environment. The challenge however, is finding suitable alternatives to investment grade bonds which traditionally have afforded good protection against stock declines but today look to deliver meager returns.**

George Guerin
1947-2017

The ISG family suffered a tragic loss recently with the passing of one of its advisory team members. George Guerin, who only 12 months earlier had merged his successful practice with ISG's established team, passed away unexpectedly on December 16, 2017.

Our heartfelt condolences go out to George's wife Rhoda, their family members, and the many clients George served who not only looked upon him as their advisor, but as a trusted friend. George was 70 years young.

Tug of War

Our 2018 outlook assumes a tug of war is building between reduced monetary stimulus and faster global growth, with the scale tipping slightly in favor of faster growth. This should drive many equity markets higher. In the U.S, we look for above trend real GDP growth of at least 2.5% with household and corporate tax cuts and higher government spending adding some momentum to an economy that is currently performing better than expected. An important development will be whether the campaign promise of increased infrastructure spending gets fulfilled, as this additional fiscal shot in the arm could further goose short-term growth prospects and selectively enhance earnings prospects which will help further advance U.S. stock prices.

Investors, however, should prepare themselves for a more turbulent ride this year. Coming out of the Great Recession, markets have remained uncharacteristically tranquil. For the most part, bad news has come and gone without causing too much disruption. But short term interest rates are headed higher and if the markets sense a whiff of renewed inflation, long-term rates may follow suit. This creates more uncertainty and volatility in the bond markets which, in turn, could spill over to

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stocks. Should there be a return to increased, more "normal" levels of stock market volatility, investors might misinterpret this as another impending financial crisis and be tempted to sell into every market correction. Our conversations with clients suggest that the scars of 2008 have not fully healed and investors remain skittish despite the relative calm in financial markets in recent years. Managing clients' emotions may be ISG's biggest challenge in 2018 should volatility return.

For now, we remain cautious, but constructive on U.S. stocks. Monetary overkill (raising short rates too much, too fast and squelching the recovery) is always a risk but our sense is the Fed policymakers will be careful not to disrupt markets. Wage and/or price inflation looks to be finally creeping up but not enough yet to offset expected earnings growth, the key element behind further U.S. stock advances in 2018.

Foreign Stocks Have Room to Run

We believe the rest of the world is at least a couple years behind the U.S. in terms of economic recovery from the Great Recession. Thus, it's likely that the runway for improvement may be longer from today's starting point than in the U.S. which is entering its eighth year of economic and earnings recovery. In the Eurozone, we see chances for an even stronger economic acceleration than in the U.S. Noncompetitive and inflexible labor market regulations which have held back growth have diminished, core inflation remains very low at around 1%, consumers are starting to unleash several years of pent-up demand, and the European Central Bank will continue to be more accommodative than the Federal Reserve. This is leading to a broad-based recovery across the region, with less disparity between member states' growth rates than in earlier years. This improving outlook combined with modestly cheaper stock prices (vs. the U.S.) should create a fertile environment for astute stock pickers in the year ahead.

Elsewhere, Japan looks to see a continuation of firm but slow growth and many other Pacific Rim economies are in recovery mode, so stock-picking opportunities remain plentiful. All eyes will be on China because as China goes, so goes many smaller, emerging market economies which depend on the world's second largest economy as a customer and supplier. Its economic health also has significant indirect effects on the world's trading patterns and commodity prices. For now, we expect a controlled deceleration of China's GDP growth to a level that industry colleague, Pimco, thinks will come in around 6.25% in 2018. The authorities' focus will likely be on controlling credit excesses and house price inflation but some offset may come in the form of more infrastructure investment that is trying to tie China more closely to its Eurasian trading partners (The "One Belt, One Road Initiative"). Stay tuned.

Shoring Up Our Defense

While our global investment outlook is generally upbeat, as always, there are some caveats. Debt levels remain high in the developed economies. Privately held debt remains far below pre-financial crisis levels but this has been offset by the continued high level of government borrowing. In the U.S., tax cuts and increased federal spending look to add around $1 trillion to the public debt over the next 10 years (according to the Joint Committee on Taxation estimates) without adding much to potential growth. In the emerging economies, both private and public debt ratios have climbed to new highs, with China leading the charge. For now, these debt levels are manageable but it remains to be seen how economies and financial markets which have become addicted to easy monetary policies may react should interest rates rise causing debt service levels to rise.

Inflation, to date, has remained stubbornly low across much of the globe. Structural forces like globalization and technology which have reduced workers' bargaining power and increased global competition are partly the reason. In the U.S., adding significant fiscal stimulus at a time when the world is enjoying a synchronized expansion could re-ignite inflation to overshoot current expectations. Wage and price inflation appears to be creeping up and recent rises in commodity prices are developments which warrant close monitoring.

Finally, Trump's trade rhetoric has been far more protectionist than any of his actions but should global trading patterns deteriorate with the outbreak of a trade war, markets would likely not react kindly to this uncertainty and the accelerating inflation caused by export restrictions placed on low cost producers like China and Mexico.

Given ISG's commitment to preserving wealth and retirement lifestyle aspirations, we believe it is prudent to err on the side of caution when factoring in some of the aforementioned uncertainties to our global outlook, so "hoping for the best, but preparing for the worst," is our ongoing narrative for most clients. The mainstay of portfolio risk management has always come in the form of high quality bonds, which tend to hold their value during stock market setbacks. Today's environment for high quality bonds however, is challenging given their low starting yields and the prospect of higher rates (which depress prices) in the future. We have written, ad nauseam, in past newsletters about our efforts in exploring various prudent alternatives to time-tested bonds and these alternatives have shown up in our "hybrid" bucket in the form of private, income-producing real estate, natural disaster-linked bonds, and more economically-sensitive but higher-earning bond strategies. We intend to continue searching for alternatives that will provide the best combination of return and protection against stock risk exposure in light of the challenging conditions facing history's best diversifier (bonds).

More than a Performance Report

ISG prides itself on the careful stewardship of your hard-earned investment assets, but keep in mind we strive to serve your comprehensive financial planning needs. One of our clients recently came to us, wondering whether retirement from her current profession was a viable option. After several meetings with one of ISG's Certified Financial Planners and the client's advisor, ISG determined that she and her husband had the financial flexibility to sell their business and meet their retirement, travel and college savings goals. Additionally, with the help of another ISG advisor, we counseled the clients through the pro's/con's of their selling options (seller financed, selling to an employee vs. outside firm, etc.).

Later, the clients expressed their appreciation for the peace of mind they were afforded by going through this process. In future newsletters, we will share more real life examples detailing how ISG's range of support and guidance extends beyond the handling of your investments.

As the World Turns: Asia's Growth Story

Rising wages and productivity are some factors behind Asia's burgeoning consumer appetite. A few tidbits:

Asia's "global middle class consumption," defined by the OECD (Organization for Economic Co-operation and Development) was around 20% of total world market share in 2000. By 2050, that share is expected to be closer to 70%.

China's real compound annual growth rate of consumption in the last 6 years was 8.7% versus 1.6% for the U.S.

Real income in China rose 130% over the last decade, vs. about 11% for the U.S.

Chinese, Indians, and South Koreans are most optimistic about their countries' futures, with a range of 74% to 87% believing their "country is on the right track." Meanwhile, 43% of Americans polled feel similarly.

Source: Ipsos Public Affairs poll, 18,557 adults aged 16-64 in 26 participating countries, June 23-July 7, 2017)

Cameron Acres, CFP

One of our advisory team members, Cameron Acres, recently obtained his Certified Financial Planner designation.

Congratulations Cameron!