The Longer View

COMMENTS AND OUTLOOKS FROM LONGER INVESTMENTS INCORPORATED

January 4, 2018

Stocks and bonds ended the year 2017 on a strong note, both domestically and internationally. Consider the U.S. index performances below:

Table 1

Index	2017 Return
S&P 500 (cash basis)	19.4%
Morningstar Dividend Yield Focus Index	13.5%
CRSP U.S. Large-Cap Value Index	14.3%
S&P Small-Cap 600 Value Index	11.5%
S&P Energy Index	-3.8%
S&P Technology Index	36.9%

International markets were equally strong. European stocks rose 20.9%, as measured by the MSCI Pan-Euro Index. Asia stocks rose 30.7%, as measured by the MSCI AC Asia Index.

The Bond Market

The Barclay's 1-5 Year Government/Corporate Index was up 1.3%. The Barclay's Aggregate Bond Index was up 3.5%.

The Federal Reserve (the Fed) raised the interest rate on federal funds three times in 2017. The most recent increase, in December, took it from 1.25% to 1.50%. The Fed was responding to stronger economic growth: an annualized rate of 3% real GDP through September 30. Unemployment fell to 4.3%, which tightened the labor market and increased concerns about wage price inflation. So far, however, inflation has remained tame. It was 2.2% during 2017. Although short-term rates were increased three times during the year, long-term rates did not move significantly from 2016's closing levels. (See Table 2.)

Table 2

U.S. Treasury Yield Curve

Maturity	12/31/16	12/31/17
Two-Year	1.19%	1.89%
10-Year	2.43%	2.41%
30-Year	3.05%	2.74%

During 2017, we opportunistically and successfully traded the long end of the yield curve by using a 20+year U.S. Treasury exchange-traded fund. That is why our fixed-income returns significantly outperformed the passive bond index returns (the returns a buy-and-hold investor would earn). We do not now own any long-term taxable bonds. We consider the risk of rising rates, which lead to declining bond prices, to be significant in the new year. If economic growth surprises to the upside due to passage of the new tax reform legislation, it is possible long-term rates will rise. But at this point, we prefer to own fixed-income investments (in the taxable fixed-income asset class) that are short or moderate maturities and investment-grade only.

We continue to achieve income returns in excess of bond returns in our "other income" asset class. This class includes domestic and international funds that invest in preferred stocks, energy limited partnerships, "Build America Bonds," and high-dividend stocks. These assets provide a better income return than bonds do, as well as a growth component. "Other income," which currently makes up approximately 17% of our portfolios, delivered excellent returns in 2017, well in excess of bond returns.

Equities

The year 2017 seemed to be all about politics, in particular, the actions of the new president, Donald Trump. He failed to persuade Congress to pass his key health legislation, Obamacare reform, but he did succeed in pushing through a major tax reform bill. The stock market rallied throughout the year, although there were divergences between sectors. The strongest returns came from technology stocks, especially the FANG stocks — Facebook, Amazon, Netflix, and Google (now called Alphabet). See Table 1 for performance of the stock market and select sectors.

The new tax program is the biggest tax reform in 30 years — since President Ronald Reagan's tax plan in the 1980s. The 2017 tax package is expected to boost U.S. real GDP growth by 0.25% to 0.50%

a year in 2018 and 2019. That result would reduce the already low risk of recession over this period. Estimates for real GDP growth in 2018-2019 are 3.0% to 3.5%. The impact of tax reform on S&P 500 earnings growth is expected to be 10% to 15%. Analysts expect S&P 500 earnings per share for 2018 will range from $144 to $151. At the end of 2017, the market was trading at a historically rich valuation, a price to earnings (P/E) ratio of 21 times the estimate of $129 for that year. (See Chart 1.) If the valuation holds at the heady level of 21 times earnings, and if tax reform brings earnings to $144, we could see the S&P 500 hit 3024, or 13.1% higher than it was at the close of 2017.

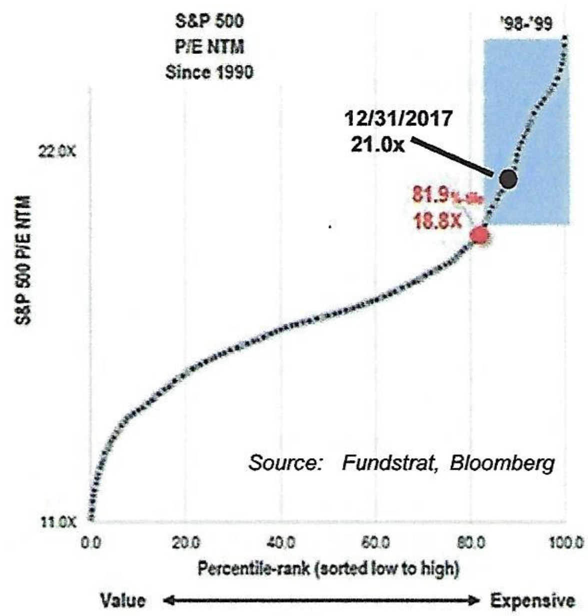
But our outlook is a bit more cautious. The current valuation, 21 times earnings, is high on a historical level. If stronger growth and/or stronger inflation numbers cause the Fed to raise rates aggressively next year, the interest-rate-sensitive P/E multiple (valuation) on the market could contract. In that scenario, even while earnings expand, the valuation applied to the earnings (P/E multiple) could contract, resulting in a flat to negative overall performance.

So, the question for investors is whether the good news — less regulation and lower tax rates — has already been discounted into today's rich market valuation. As we await more data, we favor companies with strong balance sheets and consistent dividends and cash flow. If the tax cuts result in increased domestic investment by U.S. corporations, we believe that cyclical companies (whose fortunes rise and fall with the economy) will continue to prosper.

The information provided herein is illustrative only. It should not be construed as a formal recommendation by Longer Investments Inc.

Chart 1

Rank of S&P 500 P/E Since 1990



There are a lot of questions to sort out in the coming weeks. Will the tax savings (and repatriation of assets held abroad) be used for share repurchases and higher dividends for shareholders? Or will they be invested in U.S.-based manufacturing that creates jobs? We will be monitoring the news to assess the winners and losers under the new legislation.

We wish all of you and your families a happy, healthy new year. We feel honored to be entrusted with the management of your financial assets. Each day, we seek to justify your trust in the work we do. If you have any particular questions, or if you would like to set up a meeting to discuss your account, please feel free to call us. Happy new year from all of us.

Elaine Longer

LONGER INVESTMENTS INCORPORATED

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