

REVIEW & OUTLOOK - 4Q2017

Investor's Update

As we close the year on 2017, investors have had a lot to digest. The U.S. pulled out of the Paris Climate Accord; hurricanes, Harvey, Irma and Maria hit the U.S.; White House staff turmoil; the rise of hundreds of cryptocurrencies; a power struggle in the kingdom of Saudi Arabia; and U.S. tax reform. Markets still moved higher, seemingly undaunted by any cause of concern. In fact, the Dow Jones Industrial Average had a nine-month winning streak, something that hasn't happened since 1959ⁱ.

Major markets finished higher in the fourth quarter with the Dow Jones Industrial Average and S&P 500 up 11.0 percent and 6.6 percent with income, respectivelyⁱⁱ. The tech heavy, Nasdaq Composite posted a 6.6-percent quarterly return and logged a whopping 29.7-percent return for the yearⁱⁱⁱ. The Russell 2000 Small Cap index fared the worst out of the major indices up 14.6 percent in 2017. Emerging markets had their first strong year since 2010. India and Brazil finished strong up 29.6 percent and 26.9 percent for the year. Monetary stimulus and negative rates in Japan helped stocks, and Japan finished the quarter up 12.0 percent to finish the year up 21.3 percent. China was the only major country to finish down 2.7 percentⁱⁱⁱ in 2017.

With global growth comes rising inflation pressures, which are good for commodities. Energy rebounded sharply higher in the fourth quarter with oil up 16.9 percent. Natural gas continues to suffer from over supply, and it finished lower by 1.8 percent. We continue to expect commodity price momentum to help determine the tug of war between deflation and reflation moving forward. This is a key market signal we are watching closely. Metals were higher with gold and silver up 2.2 percent and 2.8 percent respectively. Supply shortages and a pickup in demand sent copper up 11.7 percent during the quarter.

For bond investors, the yield curve flattened significantly during the quarter. The 10-year U.S. Treasury bond yield closed at 2.41 percent, while the 2-year U.S. Treasury bond yield ended at 1.88 percentⁱ. The 2/10 spread or the difference between the 2- and 10-year U.S. Treasury yields was only 53 basis points. This was the lowest spread we have seen since October 2007. A flattening spread is often perceived to be a harbinger of slower economic growth, yet the dovish accommodation still being provided by the European Central Bank and the Bank of Japan has fueled an interest rate differential that has dampened long term interest rates in the U.S. The international demand through bond flows from negative or low interest rate countries to our U.S. bond market will not last forever. As interest rates globally continue to move up, U.S. interest rates will be dragged even higher. We continue to remain in short- to intermediate-term bonds and look to compound near-dated maturities into higher rates in the future. The fixed-income indices were mixed on the quarter with the Bloomberg Barclays Aggregate Bond index up 0.4 percent during the quarter and the Bloomberg Barclays Intermediate Government /Credit Index down 0.2 percentⁱⁱ.

Closing Prices 12/31/2018	
DJIA	24,719.22
S&P 500 Index	2,673.61
U.S. Treasury Bond	
Current Yield 10-year Bond	2.407%
Current Yield 30-year Bond	2.741%

Source: Bloomberg

Economic Outlook

World economies have grown in unison as reflected by the Organization for Economic Co-operation and Development. For the first time in a decade, all 45 economies are in economic expansion. Improving economic activity outside the U.S.

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is a tailwind for both domestic growth and profits of U.S. firms with significant foreign business. Surging world growth is a precondition for higher inflation and solid foreign demand will help the Federal Reserve hit its GDP target while supporting additional but gradual monetary tightening in 2018. In addition, the administration's pro-business agenda, which includes lower corporate tax rates, increased fiscal spending and less regulation could also increase economic activity and boost company earnings.

We expect the European Central Bank and Bank of Japan to end their respective quantitative easing programs shortly. This should continue to put pressure on global inflationary forces, but as long as it is contained, incoming Federal Reserve Chairman Jerome Powell should be able to implement his predecessor's slow and cautious plan for withdrawing liquidity from the U.S. monetary system. There is plenty of evidence the Fed's plan is working. The pace of new home sales reached a 10-year high¹. The ISM manufacturing index recently saw its highest reading in September since 2004¹. Consumer confidence has hit a 17th year high¹. The economy seems to be operating on all cylinders. That said, if a sudden surge in consumer price or wage inflation triggers a more aggressive response from the Fed, it will more than likely be the end of this Great Moderation cycle.

Capital Market Analysis

Economic growth for most developed nations continues as central bank liquidity from several years ago works its way throughout the monetary system. The effect on capital markets these last several years has been robust. Moving into the new year, tax reform, relief from three hurricanes, defense spending and infrastructure spending should allow businesses to prosper and help keep markets elevated for now. It is clear though, we are entering a transition period in global monetary policy. Over time, higher interest rates and higher inflation will have its effect on market multiples. The perceived future value investors assign to company earnings will change, as well as areas of the market that look most favorable. As a result, how portfolios are structured will change going forward. The opportunities to add value from sector rotation and individual stock selection should be ample as dispersion and correlations break down, geopolitical risk remains high and volatility increases. Our team continues to focus on this dislocation.

In the fourth quarter, and over the past couple of years, our strategy has taken advantage of stocks that do better in an environment of deflation, global growth and a pickup in interest rates. In this strategy, our top sector weights have been Financials, Technology, Industrials and Health Care. We continue to believe we should limit exposure to Utilities, Consumer Staples, Consumer Cyclical and Materials. We believe the U.S. consumer is poised to have a good 2018, aided by rising incomes, solid balance sheets and elevated confidence about future employment and incomes. GDP growth will continue to move higher but will more than likely peak at some point next year. With regard to the stock market, bull markets do not end of old age, rather, they end from unintended consequences ranging from monetary policy, interest rates and high energy prices.

Our team continues to study the fundamental distinctions between investment and speculation. Valuation metrics are very different across sectors and industries, and we are constantly hunting for opportunities to add growth. Having the flexibility to own a combination of growth, value and income stocks has served our clients well over the long term, especially in times of market turmoil. Risk management, adhering to our discipline, being conscious of the relative price we pay for stocks and holding high quality, high shareholder friendly companies continues to be our focal point.

Summary

Some points to keep in mind over this next year. The markets have had an incredible run over the last several years. Will more of the same be in store for investors in 2018? How do investors position themselves for the future? How best can

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we keep the gains that have accumulated these last several years? How can Sterling Advisors protect the portfolios, participate in market advances, and collect a rising income along the way. We look forward to discussing these questions and more personally with you.

There will be familiar themes in 2018, but the main thesis has not changed. Interest rates and earnings will be the key drivers for stocks. The wildcard this year will be commodity prices and the impact it has on the economic expansion. We continue to follow many facets of the capital markets and take our fiduciary responsibility to safeguard and grow your assets very seriously. While our forecasts are subject to change, our commitment to the service of our clients is not. Thank you for your confidence in our team. Please do not hesitate to reach out with questions.

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Sources:

ⁱ Briefing.com

ⁱⁱ Bloomberg

Barclays Capital Intermediate Government/Credit Index: An unmanaged index based on all publicly issued intermediate government and corporate debt securities with maturities of 1-10 years. This index represents asset types subject to risk, including loss of principal. **SPDR Barclays High Yield Bond ETF:** The SPDR Barclays High Yield Bond ETF Fund uses a passive management strategy designed to track the price and yield performance of the Barclays High Yield Very Liquid Index. The High Yield Index measures the performance of publicly issued U.S. dollar denominated high yield corporate bonds with above-average liquidity. **Barclays Capital US Aggregate Bond Index:** The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). **Dow Jones Industrial Average:** The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **Dow Jones Utility Average:** The Dow Jones Utility Average is a price-weighted index designed to represent the stock performance of large, well-known U.S. companies within the utilities industry. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 2000®:** The Russell 2000® Index measures 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 representing approximately 10 percent of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. **Value Line Arithmetic Composite Index:** The Value Line Arithmetic Composite Index is an equally weighted price index of all stocks covered in The Value Line Investment Survey. Arithmetic refers to the averaging technique used to compute the average. **Lipper Large Cap Value Index and Lipper Large Cap Growth Index:** The Lipper index values are calculated using a weighted aggregative composite index formula methodology. Index performance is measured as the percentage change between the daily value and the index value at the date of the quarterly rebasing. Currently, all components are equally weighted at the quarterly rebasing. Funds that fail to meet established criteria are now removed from the index on the day of component failure and replaced quarterly. **US Dollar Index:** The ICE U.S. Dollar Index futures contract is a leading benchmark for the international value of the U.S. dollar and the world's most widely recognized traded currency index. The index is a geometrically averaged calculation of six currencies (i.e., the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc) weighted against the U.S. dollar. **Bovespa Index:** The Bovespa Index is a total return index designed to gauge the Brazilian stock market's average performance, tracking changes in the prices of the more actively traded and better representative stocks of the Brazilian stock market. **Hang Seng Composite Index:** The Hang Seng Composite Index offers a comprehensive Hong Kong market benchmark that covers about the top 95th percentile of the total market capitalization of companies listed on the Main Board of the Stock Exchange of Hong Kong. **MSCI Russia Index:** The MSCI Russia Index is designed to measure the performance of the large and mid cap segments of the Russian market. With 21 constituents, the index covers approximately 85 percent of the free float-adjusted market capitalization in Russia. **Nikkei 225:** The Nikkei 225 is a price-weighted index comprised of 225 stocks selected from domestic common stocks in the first section of the Tokyo Stock Exchange. **DAX Index:** The DAX Index tracks the largest and most important blue chip companies in the German equities market. It contains the shares of the 30 largest and most liquid companies admitted to the FWB Frankfurt Stock Exchange in the Prime Standard segment. The DAX represents about 80 percent of the aggregated prime standard's market cap.

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