Q1 2018 Quarterly Newsletter

FAILING TO PLAN IS PLANNING TO FAIL

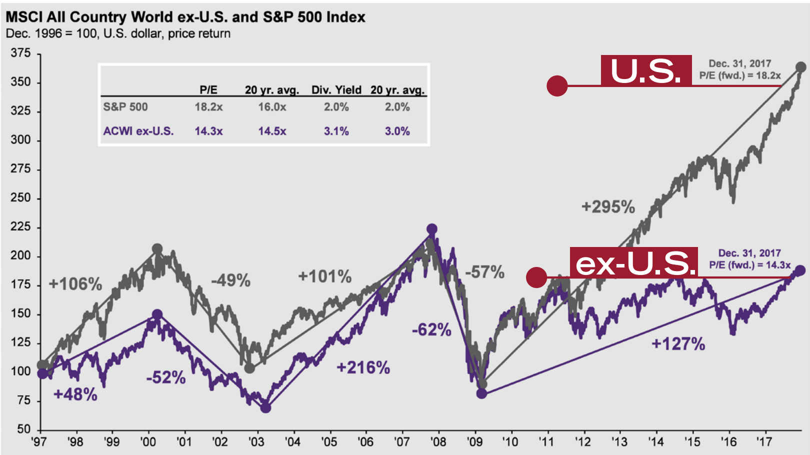
According to the NATIXIS annual Investment Manager Survey for 2018, few institutional investors are ready to strike a defensive posture, and no one wants to leave the party till it's over! As we enter the New Year, market momentum abounds with enthusiasm, driven in part by the potential benefits from the 2017 Tax Package.

Indeed, looking back, we saw significant market returns in 2017 with the major indexes posting double-digit returns:

- The Dow Jones Industrial Average (DJIA) was up **28.08%,** closing at **24,719**
- The Standard and Poor's 500 (S&P 500) Index was up **19.42%,** closing at **2,673**
- The MSCI EAFE Index was up **22.43%,** closing at **2,051**
- The yield on the 10-year Treasury Bonds was **2.41%**

[1]*Source: Bloomberg*

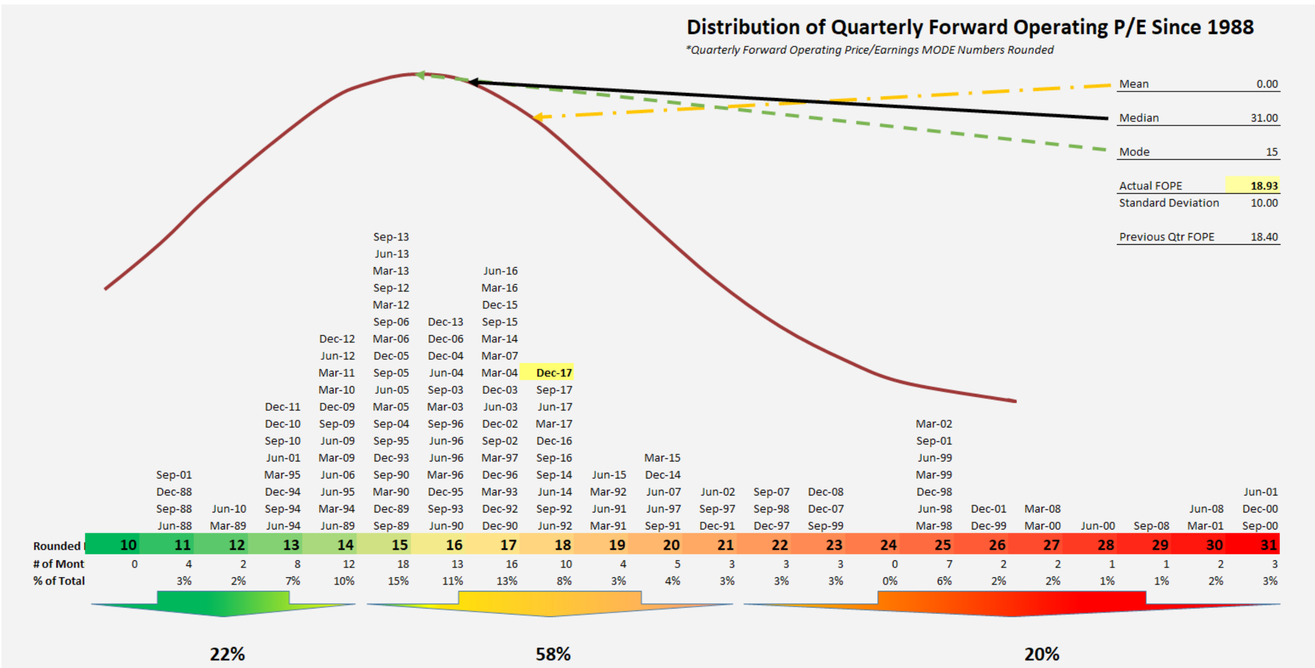
ON THE HEEL OF SUCH STRONG PERFORMANCE, WHAT WILL RETURNS LOOK LIKE IN 2018? *We believe that the equity markets can continue to provide positive returns in 2018, albeit at a lesser level, perhaps 10%.* As reflected to the right, it is clear that the U.S. stock market is the most highly priced in terms of the price/earnings ratio (P/E) when compared to other Non-U.S. equity markets. The price/earnings ratio is the measure of the share price relative to the annual net income earned by the firm per share. P/E ratio shows current investor demand for a company share. But how high is too high? In our Red Yellow Green analysis (page 2), the U.S. market as measured by one year Forward Operating Earnings (FOPE) is at 18.93. It has been in the "yellow" range for all of 2017 even though the market has risen substantially. Why? It is because the market is not expanding its multiple. It is simply maintaining its FOPE in lockstep with earnings and market increases.



[2]*Source: J.P. Morgan*

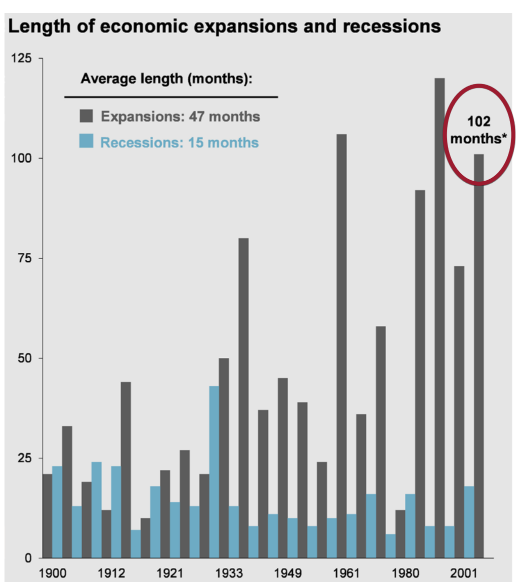
This is hardly exuberant or excessive, and why we believe there are still opportunities for higher values ahead. For example, while not in the red light zone, FOPE is near one standard deviation over the 20-year average of 16.0x and we believe could easily expand to 25x. Thus, the S&P 500 could expand to 3,456* and the DOW could expand to 31,887* before this cycle comes to a close. "Pardon me?" Yes, there was a similar level of surprise and skepticism when back in 2009, the DOW was projected to hit 25,000.

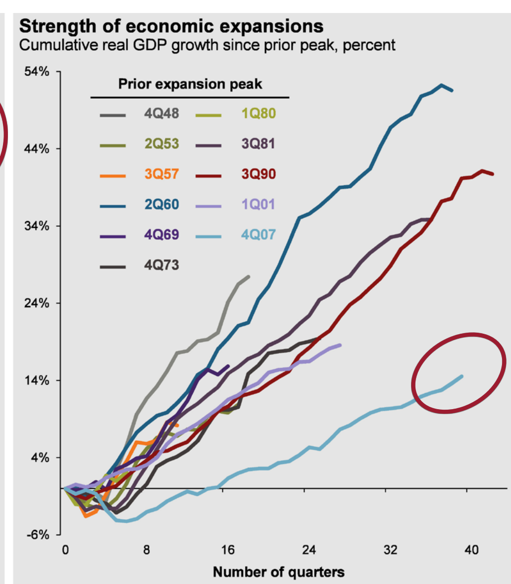
INDEED, WE BELIEVE THIS MARKET HAS THE POTENTIAL TO EXPAND ANOTHER 30%



[3]*Source: LFAM, See disclosures on last page*

Furthering our belief that this market has legs to stand on, the current "Bull" Market is now 102 months old, making it the third longest running Bull Market in U.S. stock market history. That said, this market has also experienced the most lackluster growth, as defined by GDP, of any Bull Market. GDP has grown only 14% since March 2009, while the average Bull Market has grown 20%. Thus, we believe the stock market can continue to support higher prices and expanding FOPE. With this as a backdrop, Level Four Asset Management believes that the U.S. economy could grow at a 3% rate in 2018 reflecting the ramification of the recently enacted Tax Code and synchronized global growth.





[4]*Source: J.P. Morgan*

Market Themes

The equity market performance from almost every sector has far surpassed most economists' projections for 2017 and beyond. Rather than rehash 2017 events, and in an effort to not sound overly optimistic and to present a balanced view, we are compelled to advise our clients that there are concerns with this market and now is the time to examine risk exposure and allocations.

Let us review some of the market themes that could prove negative. This includes market statistics, as well as national and geopolitical risks.

Market Statistics

1. The yield curve is flattening and could become inverted. Historically, inverted yield curves forecast a recession beginning in the next 12-18 months.[5]

2. Interest rates are rising in response to a growing domestic GDP. Neither inflation rates or excessive growth support this move by the Federal Reserve (FED). Economists see this increase as an attempt for the FED to load a bullet in its economic gun to jump-start recovery during the next recession.[6]

3. Individual investors have a historically low amount of cash reserves, coupled with investment managers having the highest ever long equity exposure. The low cash levels of individual investors were a key market indicator at three previous market bottoms: Q1 2000, Q3 2007, and prior to the 2015 sell off of 15%.[7]

4. The put-call ratio indicates extreme bullish overcrowding and hedge funds are the most leveraged and net long than they have been in the past five years.[8]

5. Margin levels are at an absolute all-time high. The current allocation to stocks is the second highest in history second only to the period of the 2000 internet bubble! Clearly many individuals may be overexposed to the equity markets at this time.[9]

NATIONAL AND GEO-POLITICAL RISKS THAT COULD IMPACT THE STATISTICS AND FUNDAMENTALS.

1. U.S. Generals have recently alerted troops that readiness must be maintained as the potential for an armed conflict is high with the Middle East and North Korea. President Trump's recent decisions regarding Israel and relocating the U.S. Embassy to Jerusalem have heightened focus on the Middle East, while Kim Jong Un continues to conduct nuclear tests.

2. The revised Tax Code passed in December 2017 will have ramifications for individuals as many of the reductions will expire in 2025 for individuals. Few investors realize this Catch-22 in the new tax law. Individual tax rates expire in 2025, yet the benefits of mortgage deductions and state tax credits would likely remain. The fact that they are not being adjusted for inflation could be a negative surprise for individuals, but not necessarily for corporations who will have the opportunity to repatriate foreign earnings and reap from the benefits.

The question is what will they do with those cash hoards if indeed the U.S. Economy is at the top of a market cycle?

3. The U.S. Congress still has a lot to address with deadlines for budget funding, healthcare, and immigration looming in the near future, and President Trump and the GOP will soon face midterm elections. Trump scored a major victory in passage of the tax overhaul, but it remains to be seen if the GOP will continue to hold House and Senate majorities.

Outlook?

We believe there is no shortage of items viewed as positive by investors. Chief among these is the repatriation of U.S. corporation's foreign profits. This may prompt large U.S. corporations to boost dividend payments or continue in share buybacks. Both are very positive. A research report by J.P. Morgan found that a basket of high dividend yielding U.S. value stocks has a forward P/E of 16.2x compared to the broader S&P 500 of 19.0x.[10] While dividend paying stocks have historically traded at a discount to growth stocks, this spread is now four times wider than normal (-2.8% vs the 10-year average of -0.8%). This indicates that value investors could experience a very good year if fund flow comes from overvalued growth stocks. Furthermore, our research indicates that we could find the best opportunities in developed international stocks, emerging markets, U.S. large cap value and small to mid-cap stocks.

The U.S. economy is now growing at or above the 3% rate—this is the ideal target that the FED would be most comfortable with.[11] This could lead to continued strength in high growth securities among all capitalization ranges. And not just so with the U.S. economy, but non-U.S. economies are also improving, and foreign markets are nowhere as highly valued as U.S. markets.

Call to Action

Finally, we hope we have spurred you to consider reviewing your overall asset allocation relative to U.S. equity exposure and question if you can withstand a potential 10% correction in the market. The time to develop an action plan is now and not after the market experiences a correction.

SOME OPTIONS TO CONSIDER ARE:

a. Adjust U.S. equity exposure by reallocating to U.S. Large-value which has not kept pace with U.S. Large-growth and generally has greater dividends.

b. Reallocate to non-U.S. equity markets which are undervalued to U.S. equity markets.

c. Reallocate a percentage of your portfolio into short-term fixed income investments that will allow you to repurchase in the event of a decline.

THANK YOU AND HAPPY NEW YEAR!

LFAM Investment Committee

IMPORTANT INFORMATION

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy assures success or protects against loss. All indices are unmanaged and may not be invested into directly. Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. The Standard & Poor's 500 index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. Developed Markets countries in the MSCI EAFE Index include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK. The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI), and is comprised of stocks from both developed and emerging markets.

[1] Index Performance - Bloomberg.
[2] MSCI All Country World, J.P. Morgan - December 31, 2017 - Guide to the markets.
[3] The graph is showing the quarter-end P/E Value of the market cap weighted S&P 500 index; calculated as end of quarter price close divided by end of quarter reported earnings. This graph also shows a normalized histogram of those same data points as outlined in red bell curve. The information represented in these tables are estimates based on the individual information of S&P 500 index holdings for each period. The underlying data is updated quarterly and has been obtained from Standard & Poor's 3rd party sources considered to be reliable but its accuracy and completeness cannot be guaranteed. This evaluation is for information purposes only and not intended as an offer, solicitation, or recommendation with respect to the purchase or sale of any securities supplied by any money management organization.

Definitions: Forward Operating P/E - is calculated using the next 12 months estimated operating earnings outlined by S&P, divided by current quarter end closing price. The mean is the sum of all the values in the set of data divided by the number of values in the same set of data. The median of a set of items is the value in the middle of an array of the items. The mode is the value that appears most often in a set of data. The standard deviation in this case, measures the level of volatility of returns measured in percentage terms.

*Target prices are computed based on earnings projections for the S&P 500 and the Dow Jones Index made by Standard and Poor's. The earnings are then multiplied by the current Forward one, two and three-year Operating Price Multiple (FOPE). The FOPE is calculated by dividing the current number value of points of the index by the forecasted operating earnings produced by Standard and Poor's. Target prices can alter dramatically if earnings forecasts prove to be inaccurate. For example, 2007 and 2008 actual operating earnings were nearly 50% beneath the forecast due to the Banking Liquidity Crisis.
[4] The Length of Economic Expansions and Recessions, J.P. Morgan - December 31, 2017 - Guide to the markets.
[5] Forbes - June 10, 2017 - What the yield curve is telling us.
[6] Federal Reserve - December 12, 2017 - Meeting Minutes.
[7] J.P. Morgan - December 31, 2017 - Guide to the markets.
[8] J.P. Morgan - December 31, 2017 - Guide to the markets.
[9] J.P. Morgan - December 31, 2017 - Guide to the markets.
[10] J.P. Morgan - December 31, 2017 - Guide to the markets.
[11] Dallas Federal Reserve - January 2, 2018 - U.S. Economy Research.

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