CHIEF INVESTMENT OFFICE

The Weekly Letter

DECEMBER 5, 2017

C. I . O .

M S T.

E D. H

Director

→ **E- : T H ?:** The big surprise in Europe in 2017 has been the extent to which Brexit and Trump fears have not materialized as a more moderate middle ground seems to be playing out. While European leaders are currently feeling cocky about their economic progress, we believe this upturn is purely cyclical and will end once the expansion loses steam, and that structural reforms are needed to ensure a more stable and robust monetary and financial union.

→ **M R :** Last week equities were mixed, with the S&P 500 up 1.6% while international equities, as measured by the MSCI EAFE Index, fell 0.9%. Bond prices moved slightly lower, as the 10-year Treasury yield rose 2 basis points to 2.36% from 2.34% the previous week. Commodities, as measured by the Bloomberg Commodity Index, fell 0.6%, with WTI crude down 1.0% to $58.36 per barrel. Gold fell 0.6% to finish the week at $1,280.50 per ounce.

→ **L A :** Among data releases this week, the Bureau of Labor Statistics puts out the November employment report, the University of Michigan reports December's Consumer Sentiment Index and the U.K. Office for National Statistics provides Industrial Production for October.

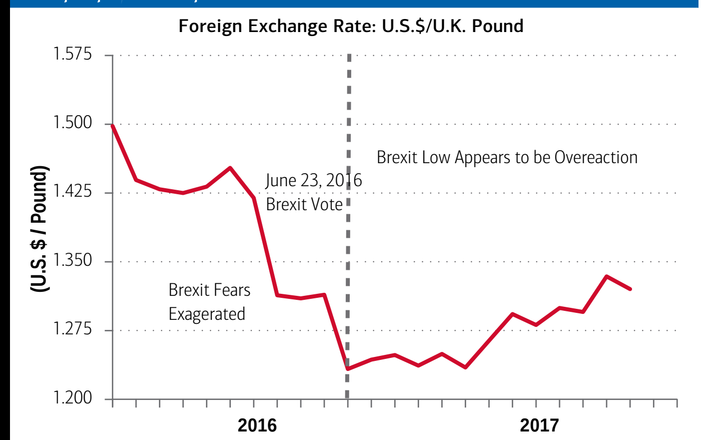
Europe: Tailwinds to Headwinds?

On the heels of the su [redacted] there was heightened [redacted] order was vulnerable [redacted] negative for risk asse [redacted] the global establishm [redacted] circled the wagons in [redacted] that had worked so w [redacted] several decades.

Relatively underappre [redacted] possibility that populi [redacted] imbalances that the l [redacted] including the sharp ri [redacted] middle-income wage [redacted]

The big surprise in 20 [redacted] extreme Brexit and Tr [redacted] moderate middle grou [redacted] not only breathed a si [redacted] the anticipation of ref [redacted] had been building for [redacted] fundamental strength [redacted]

E 1: T B



Source: Federal Reserve/Haver Analytics. Data as of November 1, 2017.
Past performance is no guarantee of future results.

[redacted] st time in about 10 years, all regions of the world [redacted] ng together. One of the fruits of this synchronized [redacted] ansion has been robust corporate profitability. Over [redacted] r, for the first time in about five years, equity [redacted] cked by BofA Merrill Lynch (BofA) Global Research [redacted] l Earnings Revision Ratio upgraded the earnings [redacted] more stocks globally than they downgraded. This [redacted] continued into November, is typically associated [redacted] equity markets.

[illegible]

The positive trends in corporate profitability may still have room to run, especially in Europe. Unlike in the U.S., where corporate earnings have surpassed their pre-crisis peak, in the European Union they are still lagging significantly, suggesting more potential upside for them as well as margins and return on equity.

The British pound, which provides the main market-based indicator of Brexit fears, has stabilized and even risen about 7% from a year ago (see Exhibit 1). Investors who stayed the course on U.K. equities following the surprise outcome of the referendum have been rewarded. From July 1, 2016 to December 1, 2017 British stocks had a total return of 17% in local currency and 13% in U.S. dollars. What's more, the local U.K. MSCI index was tracking the performance of the S&P 500 very closely until recently, when the latter took off on optimism over tax reform (see Exhibit 2).

[illegible]

While populist parties gained strength in elections in the Netherlands, France, Austria and Germany, the center held sufficiently to prevent an imminent existential crisis for the continent's ongoing integration project.

In France, Emmanuel Macron was able to combine populist concerns for reform with a strong commitment to the Euro project in his overwhelming victory. The labor market and welfare reforms, coupled with fiscal discipline, could be positives for the French economy and its equity market if they go through.

Unfortunately, the eurozone's future remains overly dependent on reluctant German leadership. Ms. Merkel's party, the Christian Democratic Union, had its worst showing since 1949, dropping from 49% of the Bundestag to just 33%. The big winners were the right-wing populist Alternative for Germany party and the Free Democratic Party (FDP). While the FDP is pro-euro, it is also for tighter border controls and generally composed of hard-line resisters to the reforms that are needed to strengthen the institutional framework for a more robust monetary and fiscal union.

The failure of negotiations to form a government that includes the FDP, and the increasing likelihood of bringing the Social Democratic Party back in the ruling coalition, comes as a relief to those committed to the European project. But despite Germany's political turmoil its economy is powering on. Exports remain robust, business and consumer confidence is rising, and so are German equities (see Exhibit 2).

[illegible]

While European leaders are currently feeling cocky about their

Markets in Review

K C
Analyst

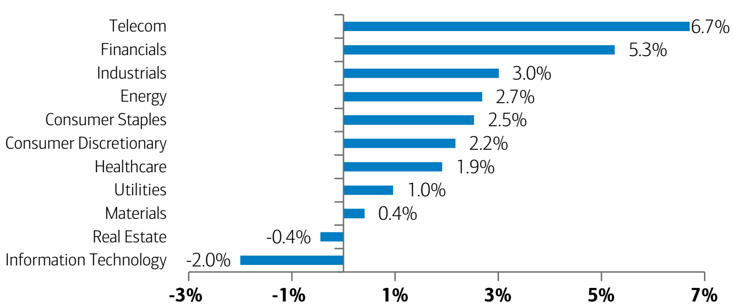
T E R

Pending Home Sales rose 3.5% in October, well above the consensus expectation of a 1.0% month-over-month increase and the most in eight months, according to the National Association of Realtors. Among underlying trends are steady hiring, easier credit availability and historically low borrowing costs.

Growth in U.S. Personal Consumption Expenditures came in at 1.4% for October, in line with the consensus expectation and little changed from September's level, according to the Bureau of Economic Analysis.

China's National Bureau of Statistics released its Manufacturing Purchasing Managers' Index for November at 51.8, slightly above both the consensus expectation of 51.4 as well as October's 51.6 reading. A level over 50 represents growth.

S&P 500 S R (12/1/17)



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		T R USD (%)		
	L	TD	MTD	TD
DJIA	24,231.6	3.0	-0.2	25.5
NASDAQ	6,847.6	-0.6	-0.4	28.5
S&P 500	2,642.2	1.6	-0.2	20.3
S&P 400 Mid Cap	1,894.6	2.0	-0.2	15.7
Russell 2000	1,537.0	1.2	-0.5	14.6
MSCI World	2,069.4	0.5	-0.4	20.3
MSCI EAFE	2,003.7	-0.9	-0.8	22.1
MSCI Emerging Mkts	1,115.9	-3.3	-0.4	32.0

F I

		T R USD (%)		
	(%)	TD	MTD	TD
ML US Broad Market	2.65	0.0	0.3	3.4
ML 10-Year US Treasury	2.36	-0.1	0.4	2.7
ML US Muni Master	2.36	0.1	0.4	4.8
ML US IG Corp Master	3.26	0.1	0.4	6.0
ML US HY Corp Master	5.77	0.1	0.0	7.2

C & C

		T R USD (%)		
	L	TD	MTD	TD
Bloomberg Commodity	176.3	-0.6	0.9	-0.3
WTI Crude $/Barrel[1]	58.4	-1.0	1.7	8.6
Gold Spot $/Ounce[1]	1,280.5	-0.6	0.4	11.1
L	C	P E	P M E	2016 E
EUR/USD	1.19	1.19	1.19	1.05
USD/JPY	112.17	111.53	112.54	116.96

Source: Bloomberg.[1] Spot price returns. All data as of the 12/1/17 close.
Past performance is no guarantee of future results.

Looking Ahead

U. E R

On Friday, the Bureau of Labor Statistics publishes November's employment report. BofAML Global Research forecasts nonfarm payroll growth of 210,000, above the consensus expectation of 198,000 but below October's increase of 261,000. Employment indicators from the Empire State and Philadelphia Fed surveys were positive, implying steady hiring activity and further job gains.

Also on Friday, the University of Michigan releases its preliminary Consumer Sentiment Index for December. BofAML Global Research forecasts a reading of 99.0, above the consensus expectation of 98.0, but below its cyclical high of 100.7 in October.

On Friday as well, the U.K. Office for National Statistics reports October's Industrial Production, for which BofAML Global Research is expecting a 2.8% year-over-year increase, below the consensus expectation of 3.5% but above September's 2.5% gain.

B A M L G R K Y -E F

S&P 500 O	**2017 E**
Target	2,450
EPS	$129.00
R G D P	**2017 E**
Global	3.7%
U.S.	2.2%
Euro Area	2.3%
Emerging Markets	4.8%
U.S. I R	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.55%
C	**2017 E**
Gold ($/oz-period average)	$1,260
WTI Crude Oil ($/bbl-eop)	$50.40

All data as of the 12/1/17 close. Our 2017 S&P 500 end-period forecast: 2450 is the equilibrium target. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance. E=estimate.

Investing involves risk, including the possible loss of principal. No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT).

Past performance is no guarantee of future results.

Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets.

Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks and other sector concentration risks.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

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